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Federal Income Tax Developments: 1986

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FEDERAL INCOME TAX DEVELOPMENTS: 1986

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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1986 is the fourteenth in a series of articles published at The University of Akron School of Law. In keeping with the established format, the scope of this survey is limited to selected substantive developments in the field of income taxation.

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Gambling as a Trade or Business
Commissioner v. Groetzinger

TERRY VINCENT

In *Commissioner v. Groetzinger,*[1] the Supreme Court ruled that a taxpayer pursuing gambling activities on a full time basis, with regularity, and with a view to produce income for a livelihood, and not merely as a hobby, is engaged in a "trade or business" within the meaning of Internal Revenue Code (Code) Sections 62(1) and 162(a).[2] Respondent, Robert P. Groetzinger, gambled at greyhound race tracks for the better portion of the 1978 tax year.[3] He went to the race tracks six days a week, devoting sixty to eighty hours each week in gambling-related endeavors. Groetzinger's activities were confined to betting entirely on his own accord. He did not sell betting tips, collect commissions for placing bets, or work as a bookmaker. During the period at issue, he was not otherwise employed and had no other profession.

Groetzinger kept detailed records of his gambling activities, recording daily journal entries of his winnings and losses. In 1978 his gross earnings totaled $70,000 and his bets placed totaled $72,032.[4] He therefore netted a gambling loss of $2,032 for the year.

Groetzinger received income of $6,498 from other sources in 1978.[5] On his 1978 income tax return he reported only the $6,498 from nongambling sources, and did not report any of his gambling results. After an audit, the Internal Revenue Service (Service) determined that Groetzinger's winnings of $70,000 must be included as gross income and his gambling losses characterized as itemized deductions in accordance with Code Section 63.[6] As a result, Groetzinger was subject to the minimum tax on items of tax preference[7] under Section 56.[8] Thus, he owed a tax deficiency of $2,522.

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[1]107 S. Ct. 980 (1987).

[2]The Court specifically confined its opinion to the phrase "trade or business" as it appears in I.R.C. §§ 62 and 162. Although the phrase is used in over 50 sections and 800 subsections of the Code, the Court preferred not to construe the phrase as it appears in other places. 107 S. Ct. at 983 n.8.

[3]*Id.* at 192.

[4]*Id.*

[5]*Id.*

[6]*Id.*

[7]*See* I.R.C. § 57(a)(1) (1978). Items of tax preference during 1978 included "an amount equal to the adjusted itemized deductions for the taxable year (as determined under subsection (b)). *Id.* In the tax year 1978, Section 57(b)(1)(A) defined "adjusted itemized deductions" to include "deductions allowable in arriving at adjusted gross income." *Id.* § 57(b)(1)(A) (1978).

[8]I.R.C. § 56(a) (1978) states:

> In addition to the other taxes imposed by this chapter, there is hereby imposed for each taxable year, with respect to the income of every person, a tax equal to 15 percent of the amount by which the sum of the items of tax preference exceeds the greater of —
> (1) $10,000, or
> (2) The regular tax deduction for the taxable year (as determined under subsection (c)).

Groetzinger sought redetermination of the deficiency in the United States Tax Court. The Tax Court held that he was in the trade or business of gambling and as a consequence, his gambling losses did not constitute an item of tax preference for the determination of minimum tax.[9] The United States Court of Appeals for the Seventh Circuit affirmed.[10] The Commissioner appealed and because of a conflict among several circuits, the Supreme Court granted certiorari.[11]

In its analysis, the Supreme Court looked to early judicial interpretations of the phrase "trade or business." The Court traced the evolution of the judicial interpretation of the phrase "trade or business" to *Flint v. Stone Tracy Co.*[12] In that case, the Supreme Court was interpreting the meaning of "trade or business" within the Corporation Tax Act of 1909.[13] The Court there stated "'Business' is a very comprehensive term and embraces everything about which a person can be employed. . . . [A business is] that which occupies the time, attention and labor of men for the purpose of livelihood or profit . . ."[14]

Next, the Court noted that in 1940, Justice Frankfurter expressed a somewhat narrower view in his concurring opinion in *Deputy v. duPont*[15] when he stated ". . . 'carrying on any trade or business', within the contemplation of Section 23(a),[16] involves holding one's self out to others as engaged in the selling of goods or services."[17] It was the Commissioner's position in *Groetzinger* that a gambler who gambled entirely on his own accord did not offer goods or services to others and therefore failed to satisfy this trade or business requirement. The Supreme Court disagreed, stating that the Frankfurter test had never been adopted by the majority of the Court.[18] In support, the Court noted that only one year after the *duPont* decision the Supreme Court had

I.R.C. § 57(a)(1) was amended in 1978 to take effect in 1979 eliminating deductions allowable in arriving at adjusted itemized deductions. As a result, Section 56 does not apply to gambling deductions after 1978. *See* Pub. L. No. 95-600, 92 Stat. 2736 (1978).

See generally The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 201(a), 96 Stat. 411 (1982), which restructured the minimum tax. As before, those deductions allowable under I.R.C. § 62(1) are not subject to the minimum tax. Congress further eliminated deductions for wagering losses under I.R.C. § 62(1) in computing adjusted gross income through I.R.C. § 55(e)(1)(A).

[9] Groetzinger v. Comm'r, 82 T.C. 793 (1984), *aff'd*, 771 F.2d 269 (7th Cir. 1985), *aff'd*, 107 S. Ct. 980 (1987).

[10] *Groetzinger, 771 F.2d 269.*

[11] *Id. See* Gajewski v. Comm'r, 52 T.C.M. (P-H) ¶ 83, 133 (T.C.), *rev'd*, 723 F.2d 1062 (2d Cir. 1983), *cert. denied*, 469 U.S. 818 (1984); Estate of Cull v. Comm'r, 52 T.C.M. (P-H) ¶ 83, 080 (T.C. 1983), *rev'd*, 746 F.2d 1148 (6th Cir. 1984); Noto v. United States, 598 F. Supp. 440 (D.N.J. 1984), (affirmed without explanation) 770 F.2d 1073 (3d Cir. 1985); and Nipper v. Comm'r, 52 T.C.M. (P-H) ¶ 83, 644 (T.C. 1983), 746 F.2d 813 (11th Cir. 1984) (per curiam) (unpublished order).

[12] 107 S. Ct. at 983. *See Flint*, 220 U.S. 107 (1911).

[13] Tarriff Act of 1909, Pub. L. No. 61-5, 36. Stat. 11.

[14] 220 U.S. at 171.

[15] 107 S. Ct. at 984. *See duPont*, 308 U.S. 488 (1940) (Frankurter J., concurring).

[16] I.R.C. § 23(a) (1939) is the predecessor of I.R.C. § 162 (1954).

[17] 308 U.S. at 499 (Frankfurter, J., concurring).

[18] 107 S. Ct. at 985-86.

before it a case with essentially the same facts[19] and ignored the criteria as set out by Justice Frankfurter. In *Higgins v. Commissioner,*[20] the Court stated "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."[21] The *Higgins* Court barely addressed the different interpretations of "trade or business" offered by the government[22] and the taxpayer.[23] It did, however, note that the test in *Flint v. Stone Tracy Co.,*[24] was not controlling precedent because that case specifically dealt with the Corporation Act of 1909 and not the Internal Revenue Code.[25]

The *Groetzinger* Court further noted:

> although Justice Frankfurter was on the *Higgins* Court and this time did not write separately, and although Justice Reed, who had joined the concurring opinion in *duPont,* was the author of the *Higgins* opinion, the Court in that case did not even cite *duPont* and thus paid no heed whatsoever to the content of Justice Frankfurter's pronouncement in his concurring opinion. Adoption of the Frankfurter gloss obviously would have disposed of the case in the Commissioner's favor handily and automatically, but that easy route was not followed.[26]

From the cases reviewed the Court made the following conclusions:

(1) The statutory phrase "trade or business" is broad and comprehensive;

(2) The Frankfurter observation in *duPont* had never been adopted by a majority opinion of the Court, either specifically or by interpretation; and

(3) although the case law reviewed gave results, it gave little general guidance in determining the case presently before it.[27]

Adhering to the general position of the *Higgins* Court, the Court then looked to the facts and circumstances in this case and what it regarded as the common-sense concept of the term "trade or business." Groetzinger pursued his activity in good faith on a full-time basis, with regularity and with a view to produce income for his livelihood.[28] The Court stated that under these facts "...

[19]*See* Higgins v. Comm'r, 312 U.S. 212 (1941). Both *Higgins* and *duPont* dealt with investors who deducted expenses relating to the management of their own securities portfolios.

[20]*Id.*

[21]*Id.* at 217.

[22]The government urged "mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy." *Id.* at 215.

[23]The taxpayer urged "that the elements of continuity, constant repetition, regularity and extent differentiate his activities from the occasional like actions of the small investor." *Id.*

[24]*Flint,* 220 U.S. 107.

[25]Although the Court chose not to accept the broad definition of "trade or business" laid down in *Flint* the Court did not specifically overrule that decision. Perhaps if it had, Justice Frankfurter's narrowing language may well have been adopted in this decision.

[26]107 S. Ct. at 985.

[27]*Id.* at 985-86.

[28]*Id.* at 988.

it would seem that the basic concepts of fairness (if there be much of that in the income tax law) demand that [Groetzinger's] activity be regarded as a trade or business . . ."[29] within the meaning of Code Sections 62 and 162.

In *Groetzinger* the Supreme Court established that a taxpayer need not hold himself out to others as being engaged in the selling of goods or services to be in a trade or business. Whether a taxpayer is engaged in a trade or business will be judged on a case by case basis looking to the individual facts and circumstances of that case. What specific facts and circumstances are required is still somewhat of an open question.[30] Perhaps this broad interpretation may well "wreak havoc on the concept of trade or business"[31] or simply require further judicial interpretation.

Progressive Slot Machine Jackpots Deductible Under Accrual Method United States v. Hughes Property, Inc.

MARTIN J. BOETCHER

The United States Supreme Court recently held that casino operators who use the accrual method of accounting can deduct as business expenses jackpots guaranteed for payment on progressive slot machines that had not yet been won by playing patrons.[1] The Court stated that under the accrual method a taxpayer is entitled to deduct an expense in the year in which it is incurred. An expense is incurred in the year when all the events have occurred which establish liability and when the amount of liability can be determined with reasonable certainty.[2] This "all events test" is satisfied when the last patron plays a progressive machine at the close of the fiscal year because progressive jackpots are guaranteed to be paid to some future patron. The Nevada Gaming Commission forbade reducing the jackpot without paying it thereby fixing liability.[3]

The respondent, Hughes Properties, Inc., is a Nevada corporation which

[29] *Id.* at 986.

[30] For instance, the *Groetzinger* Court stated that Groetzinger was a "full time" gambler and that he had "no other" profession. Is the "full time" criterian necessary and may the taxpayer also maintain another livelihood? *See, e.g., Estate of Cull,* 52 T.C.M. (P.H.) ¶ 83,080, *rev'd,* 746 F.2d 1148 where the Sixth Circuit implicitly extended the scope of "trade or business" to persons other than those engaged in gambling activities on a full time basis.

[31] Ditunno v. Comm'r, 80 T.C. 362, 372 (1983) (Tannenwald, C.J., dissenting). Chief Judge Tannenwald dissented, preferring to adopt the Frankfurter concept of "trade or business".

[1] United States v. Hughes Properties, Inc., 106 S. Ct. 2092 (1986). Justice Blackmun delivered the opinion of the Court, in which Brennan, White, Marshall, Powell, Rehnquist, and O'Connor joined.

[2] *Id.* at 2096-97. Treas. Reg. § 1.461-1(a)(2) (1977) requires that all the events must have occurred which establish the fact of liability and that the amount can be determined with reasonable certainty.

[3] 106 S. Ct. at 2097. *See* United States v. Anderson, 269 U.S. 422, 441 (1926) for origin of the "all events test."

owns Harolds Club, a gambling casino in Reno, Nevada.[4] It keeps its books and files its federal income tax returns under the accrual method of accounting. Respondent owned and operated several slot machines known as "progressive machines." A progressive machine, like a regular slot machine, pays fixed amounts when certain symbol combinations appear on its reels. But a progressive slot machine has another jackpot which is won only when a different specified combination appears. The progressive jackpot increases according to a ratio determined by the casino as money is gambled on the machine. The amount of the progressive jackpot at any given time is registered on a payoff indicator on the face of the machine. The amount continues to increase as patrons play the machine until the progressive jackpot is won or until a maximum is reached."[5] According to strictly enforced Nevada Gambling Regulations, no progressive jackpot payoff indicator is permitted to be turned back to a lesser amount unless someone wins the jackpot.[6]

"At the end of the fiscal year, [the casino] entered the total of the progressive jackpot amounts as shown on the payoff indicators as accrued liability on its books.[7] The casing then subtracted the corresponding prior year figure to arrive at the current year's increase in accrued liability. The casing took this net figure as a deduction under Section 162(a) of the Internal Revenue Code as an ordinary and necessary expense 'paid or incurred during the taxable year in carrying on any trade or business.'"[8] The I.R.S. disallowed the deduction. The Claims Court granted respondent a summary judgment allowing the deduction.[9] The Court of Appeals for the Federal Circuit affirmed.[10] The Supreme Court granted certiorari because the Federal Circuit's decision conflicted with the Ninth Circuit's decision in *Nightingale v. United States.*[11]

It was not disputed that under the accrual method of accounting, a taxpayer is entitled to deduct an expense in the year it is incurred.[12] Nor was it disputed that for an expense to be incurred within that year, all the events must have occurred which establish the fact of liability and the amount of liability must be capable of being determined with reasonable accuracy.[13] Here, the Service argued that all the events which determine the fact of liability had

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[4] 106 S. Ct. at 2094.

[5] *Id.*

[6] *Id.* Nev. Gaming Reg. § 5.110.2 (1972) states, "no payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player or unless the change in the indicator reading is necessitated through a machine malfunction . . ."

[7] 106 S. Ct. at 2095.

[8] I.R.C. § 162(a) (1977).

[9] *See* Hughes Properties, Inc. v. United States, 5 Ct. Cl. 641 (1984).

[10] Hughes Properties, Inc. v. United States, 760 F.2d 1292 (Fed. Cir. 1985).

[11] 684 F.2d 611 (9th Cir. 1982) (casino using the accrual method of accounting was not entitled to deduct amounts not yet won on its progressive slot machines).

[12] *Hughes Properties, Inc.*, 106 S. Ct. at 2096.

[13] *Id.*

not yet occurred and therefore, respondent was not entitled to take a Section 162(a) deduction.[14] The Service argued that the casino's liability was not established until a patron actually won the progressive jackpot. It argued that the liability was not "fixed and certain" nor "unconditional" nor "absolute" by the end of the fiscal year because no person could yet assert any claim to those funds.[15]

The Court disagreed stating that the Nevada Gambling Commission's regulations fixed the casino's liability.[16] Nevada Gaming Regulation Section 5.110.2 forbids reducing the indicated payoff without paying the jackpot.[17] The casino's liability, its obligation to pay the indicated amount, was not contingent and would eventually be paid to a winning patron. The obligation existed even if the identity of the winning player could not be ascertained at the time the deduction was taken.[18]

Justice Stevens dissented, distinguishing between the nonpayment of an existing obligation, for which the accrual method permits a deduction, and the nonexistence of an obligation, for which no deduction is permitted.[19] Justice Stevens found that no fixed obligation was created by the Nevada Gaming Regulations. Justice Stevens noted that if the casino declared bankruptcy, it had no obligation that could be discharged.[20] Therefore, since there was no fixed obligation, the expense had not been incurred for federal tax purposes and no deduction under Section 162(a) was permitted.

The Supreme Court's decision will permit Section 162(a) business expense deductions under the accrual method even when the payee is not known but only where the liability of the taxpayer is established and it is certain that some future payee will be paid.

Unrelated Trade or Business
United States v. The American College of Physicians

PENELOPE TAYLOR

The United States Supreme Court left the door slightly open for tax-exempt treatment of certain advertising in journals published by tax-exempt or-

[14] *Id.* at 2097.

[15] *Id.* See Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979) for the fixed and certain requirement.

[16] *Hughes Properties, Inc.*, 106 S. Ct. at 2097.

[17] Nev. Gaming Reg. § 5.110.2 (1972).

[18] *Hughes Properties, Inc.*, 106 S. Ct. at 2097.

[19] *Id.* at 2100 (Stevens, J., dissenting).

[20] *Id.* at 2101.

ganizations in *United States v. The American College of Physicians.*[1] While deciding that Section 513 of the Internal Revenue Code and its regulations do not establish a *per se* blanket taxation of the activity as an unrelated trade or business, the facts and circumstances of each case must now be closely examined.[2]

The American College of Physicians is a tax-exempt medical society comprised of physicians primarily specializing in internal medicine. Among its purposes is to maintain high standards of medical education and to improve public health.[3] The College publishes a highly-respected monthly journal, *The Annals of Internal Medicine (Annals),* which includes scholarly articles as well as advertisments for pharmaceuticals, medical equipment and supplies.[4] These ads are not dispersed throughout the journal but appear in discrete clusters at the beginning and end of the publication. Advertising rates are competitive and the ads are screened for accuracy and relevancy to internal medicine.[5]

In 1975, the *Annals* produced and The College of Physicians paid taxes on a net income of $153,388.[6] The College of Physicians then filed for and was denied a refund by the Claims Court.[7] On appeal, the Federal Circuit Court reversed stating that too much emphasis was placed on the "commercial character of the advertising" by the lower court rather than the "importance of the contribution of that activity . . . to the performance of the College's exempt purposes . . ."[8]

In a unanimous decision, the Supreme Court reversed.[9] Agreeing with

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[1]106 S. Ct. 1591 (1986). Beginning in 1950, Congress enacted legislation to eliminate abuse by some tax-exempt entities engaged in activities unrelated to their tax-exempt purposes and which yielded unfair competition to regularly taxed businesses. *See* Revenue Act of 1950, ch. 994, §§ 301, 331, 64 Stat. 947, 957, *as amended,* I.R.C. §§ 504-14 (1986).

The most famous case of abuse involved New York University School of Law's purchase, through a group of benefactors, of the country's largest noodle manufacturer, C.F. Mueller Co. *See* C.F. Mueller Co. v. Comm'r, 190 F.2d 120 (3d Cir. 1951).

[2]106 S. Ct. 1591, 1599 (1986). The particular regulation construed by the Court was Treas. Reg. § 1.513-1(d) (4) (iv), Example 7. *See* 106 S. Ct. at 1596. The Service argued that this regulation created a *per se* rule of taxation for journal advertising. *Id.*

[3]*Id.* at 1592.

[4]*Id.* at 1593.

[5]*Id.*

[6]*Id.*

[7]American College of Physicians v. United States, 3 Cl. Ct. 531 (1983). In 1976, the College of Physicians successfully filed for a refund of 1968 and 1969 taxes. *See* American College of Physicians v. United States, 530 F.2d 930 (Ct. Cl. 1976). That case followed on the heels of Massachusetts Medical Society v. United States, 514 F.2d 153 (1st Cir. 1975). Both courts found that the Treasury had enlarged the scope of the statutes through its regulations which called for fracturing of the business activity. Congress validated the fracturing concept in I.R.C. § 513(c) (1986). *See* H.R. REP. NO. 413, 91st Cong., 1st Sess. at 50, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1695-96. *See also* S. REP. NO. 552, 91st Cong., 1st Sess. at 75-76, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 2104-05.

[8]American College of Physicians v. United States, 743 F.2d 1570, 1575-76 (Fed. Cir. 1984).

[9]In a concurring opinion by Chief Justice Burger and joined by Justice Powell, a plea was made for legislative action in this area in order to promote wider circulation of these journals which would benefit the general public. 106 S. Ct. at 1600 (Burger, C.J., concurring).

both lower courts in finding no *per se* taxation of advertising in the journals of tax-exempt entities, Justice Marshall wrote that the Claims Court's focus on the conduct of the College of Physicians rather than the educational quality of the advertisements was proper.[10] Indicating that all advertising has some educational aspects, taxation instead is determined by a three-pronged test. The advertising must be (1) related to a trade or business,[11] (2) regularly carried on,[12] and (3) substantially related to or contribute importantly to the taxpayer's exempt purposes.[13]

The third prong focuses on the manner in which the organization operates its business and how the advertising relates to the tax-exempt purposes. Relying on the Claims Court's findings of fact, Justice Marshall found that the College of Physicians failed to use a comprehensive presentation of its ads,[14] extended advertising to those companies willing to pay for it,[15] repeated ads from month to month,[16] and included ads with no relation to the tax-exempt purposes.[17] The advertising income was taxable as resulting from an unrelated trade or business since the third prong of the Court's test was not met.

The decision in *American College of Physicians* makes it more difficult for tax-exempt entities to enjoy a full tax-free status. Rather than simply publishing ads in a hit-or-miss fashion, care must be taken to accept ads for genuinely new products, for items which correlate to scholarly articles or for products which more obviously contribute importantly to a specific tax-exempt purpose. The characterization of the advertising as related to the entity's tax-exempt status will take careful planning.

On the other hand, the Service is no longer able to assert a *per se* determination of taxation of such activities as it apparently has done in the past.[18] It will now have to examine the individual character and application of the particular ads before ruling that the income they generate is taxable.

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[10] *Id.* at 1599.

[11] *Id.* at 1595. Relying on Treas. Reg. § 1.513-1(b) (1985), the Court recognized the fragmenting of an activity into its component parts. Advertising is analyzed in its selling, soliciting and publishing capacities and does not lose its trade or business identity even though it is part of the journal of a tax-exempt entity.

[12] 106 S. Ct. at 1595. This issue was not in dispute.

[13] *Id.* at 1599.

[14] The Court suggested that one way to satisfy the substantially-related test would be to coordinate the ads with the journal's editorial content. *Id.* at 1600.

[15] *Id.* Those companies unable or unwilling to pay for space got none even though they may have represented products which advanced the purposes of the tax-exempt entity.

[16] *Id.* The findings of the Claims Court had earlier determined that frequent advertising for established drugs such as Valium, Insulin and Maalox undermined any suggestions of alerting readers to recent developments. *See* 3 Cl. Ct. at 534.

[17] 106 S. Ct. at 1600. The Claims Court noted that an ad for another publication appeared regularly in *Annals* and offered to answer whether "the new Seville (is) worth its $12,479 base price." *See* 3 Cl. Ct. at 536.

[18] This is a deviation from the Service's past practice of simply finding the advertising an unrelated trade or business without any apparent extended analysis of the precise nature and context of the ads. *See, e.g.*, Rev. Rul. 139, 1982-2 C.B. 108 and Rev. Rul. 431, 1972-2 C.B. 281.

Business Income or Charitable Contribution
United States v. American Bar Endowment

SUZANNE STEPHENS

The American Bar Endowment (ABE), a charitable organization affiliated with the American Bar Association,[1] raises money for its charitable work by providing group insurance policies, underwritten by major insurance companies, to its members.[2] Because ABE's size gives it a bargaining power that individuals lack and because the group policy is based upon the group's claims experience rather than general actuarial tables, the underwriters' costs fall below the premiums causing the underwriter to refund the excess as a dividend.[3] Since all members are required by ABE to allow these dividends to be returned to ABE rather than pro-rated to the insured members, this enables ABE to use this money for its charitable purposes.[4]

The United States Supreme Court ruled that ABE's insurance plan is an "unrelated trade or business" and that the dividends are profits and therefore subject to taxes under Sections 511-513 of the Internal Revenue Code.[5] Pursuant to Sections 511(a)(1) and 512(a)(1), the Internal Revenue Service (IRS) audited ABE's tax returns for 1979 through 1981 and calculated the insurance dividend to be $19,000,000.[6] The IRS assessed $6,000,000 in back taxes which ABE paid and then sued in the Claims Court for a refund.[7] In addition to ABE's suit, individual participants in the insurance program, who had not deducted any part of the insurance premiums as charitable deductions, sued arguing that they were entitled to charitable deductions for a portion of the premiums paid.[8]

ABE's defense rested solely upon the proposition that its insurance program did not constitute a trade or business.[9] Both the Claims Court and the Court of Appeals for the Federal Circuit entered judgment for ABE finding that providing insurance to its members did not constitute a trade or business.[10]

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[1]All members of the American Bar Association are automatically members of the American Bar Endowment.

[2]United States v. American Bar Endowment, 106 S. Ct. 2426, 2428 (1986).

[3]*Id.* at 2429.

[4]*Id.*

[5]*Id.* at 2430. In United States v. American College of Physicians, 106 S. Ct. 1591 (1986), the United States Supreme Court established that the Internal Revenue Code sets up a three-part test to determine whether a tax should be imposed: 1) if it constitutes a trade or business; 2) is regularly carried on; and 3) is not substantially related to tax-exempt purposes.

[6]106 S. Ct. at 2429.

[7]American Bar Endowment v. United States, 4 Cl. Ct. 404 (1984).

[8]106 S. Ct. at 2429.

[9]*Id.* at 2430.

[10]American Bar Endowment v. United States, 4 Cl. Ct. 404 (1984); *aff'd*, 761 F. 2d 1573 (Fed. Cir. 1985).

The Claims Court held for the Government on the individual claims, but the Court of Appeals reversed and remanded for further fact finding.[11]

The Claims Court and the Court of Appeals relied on the reasoning of a former Court of Claims holding,[12] that an activity is a trade or business only if "operated in a competitive commercial manner." Since ABE did not operate its insurance program in this manner, the program was not a trade or business.[13] However, several circuit courts of appeals have adopted the "profit motive" test to determine whether an activity constitutes a trade or business for the purpose of the unrelated business income tax.[14] In concluding that the dividends constituted profits, Justice Marshall, writing the majority opinion for the U.S. Supreme Court, stressed that ABE members did not pay more for their insurance and therefore the rates remained competitive with the rest of the market.[15] In such circumstances, Justice Marshall concluded that "ABE's members never squarely face[d] the decision whether to support ABE or to reduce their own insurance costs."[16]

"The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed."[17] Justice Marshall stated that "this case presents an example of precisely the sort of unfair competition that Congress intended to prevent . . . If ABE members may deduct part of their premium payments as charitable contributions, the effective cost of ABE's insurance will be lower than the cost of competing policies that do not offer tax benefits."[18]

The Court also stated that individual members may not escape paying taxes by claiming part of their premiums as charitable deductions.[19] There was no showing, in the Court's view, that the individual members knew that "they could have purchased comparable insurance for less money" and that they "purposely contributed money or property in excess of the value of any benefit they received in return."[20]

Although the Court held that the insurance plan as designed was not a charitable contribution but business income (profit), the Court alluded to ways in which such a program could be considered a non-taxable contribution. First,

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[11] *Id.*

[12] Disabled American Veterans v. United States, 650 F.2d 1178, 1187 (Ct. Cl. 1981).

[13] 106 S. Ct. at 2430-31.

[14] Professional Insurance Agents of Michigan v. Comm'r, 726 F.2d 1097 (6th Cir. 1984); Carolinas Farm & Power Equipment Dealers v. United States, 69 F.2d 167 (4th Cir. 1983); Louisana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982).

[15] 106 S. Ct. at 2431.

[16] *Id.*

[17] *Id.* at 2432.

[18] *Id.*

[19] *Id.* at 2434.

[20] *Id.*

if the price of the insurance was in excess of the fair market value, then ABE could argue that its members intended to pay excessive prices as a form of contribution.[21] Second, if ABE members were given a choice between retaining their pro-rata share of dividends or assigning them to ABE, "the organization would have a strong argument that those dividends constituted a voluntary donation."[22] Third, in order for individual members to claim the excess between the premiums paid and the actual payments as a charitable contribution, they must be aware that they could purchase comparable insurance for less money and therefore intended the excess to be a gift to the ABE.[23]

The decision in *American Bar Endowment* represents an attempt to curtail tax-exempt organizations from competing with businesses whose earnings are taxed. However, if the dividends were refunded to the members and the members, at their option, voluntarily donated the money back, the individual members would be entitled to a charitable contribution deduction and the money that was returned to ABE would constitute a charitable contribution.

Tax Intercept Power Reaches the Earned Income Credit Sorenson v. Secretary of the Treasury

WILLIAM A. DUNCAN

The United States Supreme Court recently confirmed the power of the Secretary of the Treasury to intercept Earned Income Credit refunds for past due child support payments. In *Sorenson v. Secretary of the Treasury,*[1] the Court resolved an issue that had previously caused conflict among the circuit courts. The Court's decision in *Sorenson* shows continued judicial support for the coordinated efforts of the Internal Revenue Service (Service) and the states to provide relief for states which have assumed the burden of supporting a child.

In *Sorenson,* the Court was faced with determining whether the tax intercept power[2] extended to the interception of refund payments where the

[21] *Id.* at 2431. If a taxpayer makes a payment to a charitable organization which has the "dual character" of contribution and purchase, a charitable gift deduction may be available for any amount which exceeds the fair market value of the received benefit. Rev. Rul. 432, 1968-2 C.B. 104, 105; Rev. Rul. 246, 1967-2 C.B. 104. Although the Claims Court considered that the ABE could have charged lower rates by applying the dividends to the members' policies, the Supreme Court preferred to compare the ABE insurance rates to similar policy rates. The Court found the ABE rates to be similar to other available policies. 106 S. Ct. at 2431, 2434.

[22] *Id.* at 2432.

[23] *Id.* at 2434.

[1] Sorenson v. Secretary of Treasury, 106 S. Ct. 1600 (1986).

[2] I.R.C. § 6305 (1986).

source of the refund was the Earned Income Credit.[3] Stanley Sorenson was obligated under law to make child support payments for his child from a previous marriage who was in the custody of his former wife. Sorenson fell behind on his support payments forcing his former wife to apply for welfare benefits under the state's Aid for Families with Dependent Children program. In return for these benefits, she assigned the right to collect child support payments to the state.[4]

Sorenson and his present wife had a dependent child living with them and were thus eligible for the Earned Income Credit. The Earned Income Credit was due to the Sorensons for the tax year 1981. The Service retained a portion of the refund and paid it to the state to help defray the cost of child support payments the state had made.[5]

Under Internal Revenue Code Section 6305,[6] a state government may use the federal income tax collection system for collecting child support payments due to state residents. This collection is contingent upon the states showing that it has made a diligent and reasonable effort to collect child support through its own system.[7] This power is known as the tax intercept program. Under the statutory scheme, the tax intercept program extends to the offsetting of past due child support[8] obligations against any overpayments due as a refund to a taxpayer.[9]

In *Sorenson,* the Court had to determine whether a refund to the Earned Income Credit[10] was an overpayment for the purposes of the tax intercept program.[11] The Court rejected the taxpayers' arguments and held that a refund of an excess Earned Income Credit could be reached by the Service for the benefit of the state.[12]

The taxpayers' contention was that the term "overpayment" did not include a refund of the Earned Income Credit. The Court rejected this since, by its own definition in the statute, the Earned Income Credit and the procedure for its return to the taxpayers included the term "overpayment."[13] The Court also rejected the Sorensons' argument that retention of the Earned Income Credit violated the very policy for which the Earned Income Credit was de-

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[3]I.R.C. § 32 (1986).

[4]*Sorenson,* 106 S. Ct. at 1604.

[5]*Id.*

[6]I.R.C. § 6305 (1986).

[7]*Id.*

[8]42 U.S.C. § 664 (1986).

[9]I.R.C. § 6402(a)(c) (1986).

[10]I.R.C. § 32 (1986).

[11]I.R.C. § 6305 (1986).

[12]*Sorenson,* 106 S. Ct. at 1604-05.

[13]I.R.C. §§ 32, 6401(b) (1986).

signed — an incentive for the low-income wage earner to continue working rather than depend on welfare. While this policy argument was not denied, the Court rejected the promise that securing repayment for a state that has fulfilled the legal obligation of the parent in supporting a child was secondary to this incentive.[14]

By upholding the power of the Service to withhold a refund of the Earned Income Credit to offset past due child support payments, the Court showed continued support for the tax intercept program. Cooperation between the federal and state governments is furthered by the judicial system in providing reimbursement to the state for making support payments in lieu of the legally obligated parent.

Section 1983 Damages Excluded from Gross Income *Bent v. Commissioner*

FRANCES FIGETAKIS

In *Bent v. Commissioner*[1] the Tax Court declared that damages received in settlement of a 42 U.S.C. Section 1983 action are not includable in a taxpayer's gross income. Bent's settlement was a result of a judgment on the issue of liability which found that Bent's constitutional right to freedom of speech had been abridged. The Tax Court reasoned that damages in such cases are analogous to personal injury awards and are excludable from income.[2]

Bent was a high school teacher whose comments at several meetings offended school board members and a school administrator.[3] A few months later, Bent was denied retention because of his remarks and the fact that he had secretly recorded telephone calls with an administrator and the superintendent.

After his first request for a hearing was denied, Bent found other employment. Bent then sued the school board for breach of contract and violation of his rights to substantive and procedural due process and freedom of speech. The Delaware Chancery Court found that Bent's First Amendment right to freedom of speech had been abridged in contravention of 42 U.S.C. Section 1983.

[14]*Sorenson*, 106 S. Ct. at 1610.

[1]87 T.C. 236 (1986).

[2]I.R.C. § 104(a)(2) (1985).

[3]At an open meeting of the Board, Bent argued on whether custodians should be given election day off. Some board members found Bent's conduct "distasteful" and outside his area of concern. 87 T.C. at 238. At an interschool teachers' meeting the following month, Bent criticized the education program of a school administrator who was attending the meeting. The administrator found Bent's remarks to be personally offensive and "unduly critical." *Id.* at 239.

In post-trial, Bent asked for $30,000 in damages including $12,000 for wage loss differential and $12,000 for attorney fees. He accepted a $24,000 settlement. Neither the settlement check nor the release that Bent signed allocated any part of the settlement. The payor's records indicated that the settlement was $12,000 for wage loss and $12,000 for attorney fees which are specifically recoverable in civil rights cases.

Bent did not report the $24,000 as income. He deducted the $8,000 in legal fees that he had paid to reimburse the Delaware State Education Association for fees expended on his behalf.

The Tax Court agreed with Bent that the settlement was not includable in gross income. The money fell under the Code's exclusion from income of "any damages received (whether by suit or agreement) on account of personal injuries or sickness."[4] The Treasury Regulations state that such damages "means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution."[5]

Normally, in determining whether a settlement was made on account of personal injury, the court will look to the intent of the payor as the most crucial factor.[6] In *Bent*, the court decided that no inquiry into intent was necessary because the settlement was based on the Chancery Court's finding that Bent's constitutional rights had been abridged in violation of Section 1983.[7]

Next the Tax Court analyzed the nature of a Section 1983 claim and concluded that it was "more analogous to a tort-type right than to any other legal category of rights."[8] The Supreme Court, in a 1985 case, had held that Section 1983 actions were best characterized as involving claims for personal injuries.[9] Although the Supreme Court case involved a statute of limitations issue, the court in *Bent* found the analysis of the Section 1983 claim equally applicable in the tax setting.[10]

The Service argued that since $12,000 of Bent's settlement was for lost wages, Bent's claim was in the nature of breach of contract rather than a personal injury claim.[11] The court responded that lost wages may be part of compensatory damages under Section 1983.[12] In examining the record in this case, the court stated that "the element of lost wages was not an independent basis

[4]I.R.C. § 104(a)(2) (1985).

[5]Treas. Reg. § 1.104-1(c) (1985).

[6]Knuckles v. Comm'r, 349 F.2d 610 (10th Cir. 1965).

[7]87 T.C. at 249.

[8]*Id.* at 250.

[9]Wilson v. Garcia, 105 S. Ct. 1938, 1947-49 (1985).

[10]87 T.C. at 250.

[11]*Id.* at 252.

[12]*Id.* at 250. *See* Memphis Community School Dist. v. Stachura, 106 S. Ct. 2537 (1986).

for recovery but only an evidentiary factor in determining the amount by which petitioner was damaged."[13] Therefore, the $12,000 was properly excluded from Bent's income as part of the Section 1983 recovery.

The court found for the Service on the final issue of the deductibility of the $8,000 Bent paid for legal fees. The Code provides that no deduction may be taken for expenses which are allocable to a class of income exempt from taxation.[14] Thus, Bent was not permitted to deduct the $8,000.

Defamation Damages
Threlkeld v. Commissioner

ROXANN T. CONRAD

For individual income tax purposes, gross income includes "all income from whatever source derived."[1] Internal Revenue Code Section 104(a)(2) provides an exception to the gross income definition, however.[2] Section 104(a)(2) states that "gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness."[3]

Treasury Regulation Section 1.104-1(c) states that "The term 'damages received' . . . means an amount received . . . through prosecution of a legal suit or action based upon a tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution."[4]

There is great controversy in the courts as to what extent damages in actions for defamation are excludable from gross income under Section 104(a)(2). In actions for defamation, the plaintiff generally recovers damages for loss of personal reputation and professional or business reputation.

In 1982, the Tax Court, in *Roemer v. Commissioner,*[5] held that a distinction must be drawn between damages received for loss of personal reputation and loss of business or professional reputation for purposes of determining excludability under Section 104(a)(2). The court stated that only damages received to compensate a plaintiff for loss of personal reputation are excludable from

[13] 87 T.C. at 250.

[14] I.R.C. § 265 (1985).

[1] I.R.C. § 61 (1985).

[2] I.R.C. § 104(a)(2) (1985).

[3] *Id.*

[4] Treas. Regs. § 1.104-1(c) (1985).

[5] 79 T.C. 398 (1982), *rev'd* 716 F.2d 693 (9th Cir. 1983).

gross income as personal injury under Section 104(a)(2).[6] The court made clear that damages awarded for a loss of earnings or income flowing from the personal injury (loss of personal reputation) did not fall into the Section 104(a)(2) exclusion, and were, therefore, includable in gross income.

The Ninth Circuit Court of Appeals reversed the Tax Court's decision.[7] The Ninth Circuit said that the Tax Court's "analysis of this matter confuses a personal injury with its consequences and illogically distinguishes physical from nonphysical personal injuries."[8]

The court stated that damages awarded for physical injuries are not allocated between "the personal aspects of the injury and the economic loss occasioned by the personal injury."[9] Thus, it is illogical to require a recipient of a non-physical damage award to "allocate an award between the excludable and the otherwise taxable components of the damages."[10]

The court said that the relevant distinction for excludability under Section 104(a)(2) is between personal and nonpersonal injuries, not physical and nonphysical injuries.[11] Since 1922, the Internal Revenue Service (Service) has recognized certain nonphysical injuries as personal injuries.[12] The Service has also permitted the damages awarded for these injuries to be excluded from gross income.[13] Thus, the court refused to recognize the Tax Court's distinction.

The Ninth Circuit then addressed the distinction of damages as between personal and nonpersonal injuries based on the actual injury and its consequences.[14] The court said that an injury to a person's good name should not be confused with the derivative consequences of the defamatory attack.[15] The court said, "The nonpersonal consequences of a personal injury such as loss of

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[6] *Id.* at 697.

[7] *Roemer,* 716 F.2d 693.

[8] *Id.* at 697.

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.* (citing Sol. Op. 132, I-1 C.B. 92 (1922)).

[13] Sol. Op. 132, I-1 C.B. 92 (1922). The Solicitor's opinion cites Stratton's Independence v. Howbert, 231 U.S. 399 (1913) and Eisner v. Macomber, 252 U.S. 189 (1920) for the definition of income as "the gain derived from capital, from labor, or from both combined." The opinion stated that without gain of some sort no income within the Sixteenth Amendment can be realized. The opinion stated,

> In light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of these damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable . . . . If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the government can not tax him on any portion of the sum received.

Sol. Op. 132, at 93.

[14] *Roemer,* 716 F.2d at 699.

[15] *Id.*

future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect."[16]

The court recognized that an individual suffers an impairment of his or her relationship with others as a result of defamatory statements.[17] "While some of these relationships may be personal and some may be professional, all of the harm that is done flows from the same personal attack on the defamed individual."[18] Thus, the court refused to recognize the distinction between damages for personal and business reputation based on the actual injury and its consequences.

No circuit court of appeals has recognized the distinction of damage awards in defamation suits between personal reputation and business reputation as set forth by the Tax Court in *Roemer.*[19] The Ninth Circuit expressly denied such a distinction, the Second Circuit questioned it,[20] and the Sixth Circuit declined to rule on it.[21]

Thus, when the question again came before the Tax Court, the Tax Court acceded to the traditional circuit court view and overruled *Roemer.*[22]

In *Threlkeld v. Commissioner,*[23] the taxpayer, Threlkeld, settled a civil lawsuit for malicious prosecution and other claims for $300,000, of which the parties allocated $75,000 to injury to Threlkeld's professional reputation.[24] The sole issue before the Tax Court was whether the amount received in settlement of a suit for malicious prosecution that represented recovery for injury to Threlkeld's professional reputation was excludable from income under Section 104(a)(2).[25]

The Tax Court held for Threlkeld and said, "[F]or purposes of Section 104(a)(2), there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation."[26]

The Tax Court's analysis followed the reasoning of the Ninth Circuit:

We do not lightly decline to follow one of our prior decisions; no court

[16] *Id.*

[17] *Id.*

[18] *Id.* at 700.

[19] *Roemer, 79 T.C. 398, rev'd,* 716 F.2d 693.

[20] Agar v. Comm'r, 29 T.C.M. (P-H) © 60,021, (T.C. 1960), *aff'd,* 290 F.2d 283 (2d Cir. 1961).

[21] Wolfson v. Comm'r, 47 T.C.M. (P-H) ¶ 78,445, (T.C. 1978), *aff'd and remanded,* 651 F.2d 1228 (6th Cir. 1981).

[22] Threlkeld v. Comm'r, 87 T.C. (P-H) 76 (1986).

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

bound by stare decisis does. But where one of our decisions lacks a firm foundation in the case law and an appellate court issues a well-reasoned reversal of that decision, the weight of precedent must give way to a better approach. Therefore, we will no longer distinguish between personal reputation and professional reputation for the purpose of deciding whether a damage award received in a tort action is excludable from gross income under section 104(a)(2).[27]

Ordinary and Necessary Business Expenses *Hymel v. Commissioner*

JON M. DERHODES

Internal Revenue Code Section 162 allows a taxpayer a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business.[1] Where expenses that are generally of a personal nature are claimed as deductions under Section 162, the taxpayer has the burden of proving that such expenses are ordinary and necessary in carrying on a trade or business.[2]

In *Hymel v. Commissioner*[3] Roland Hymel was a wholesale and retail insurance agent. Hymel was also a member of the Krewe of Bacchus, a Mardi Gras carnival club. On his 1978 and 1979 tax returns, Hymel deducted amounts he paid as membership dues to Bacchus, claiming they were ordinary and necessary expenses of his insurance business under Section 162. Hymel claimed that his membership in Bacchus had a direct impact on his business. One of the purposes of Bacchus was to increase tourism and more tourists meant more potential customers. Hymel also claimed that his membership in Bacchus resulted in the issuance of a significant amount of life insurance policies to members of Bacchus. The Tax Court found that these claims alone did not meet Hymel's burden of proving that his Bacchus membership dues were directly related to his insurance business and held that they were not ordinary and necessary expenses of his insurance business. The Fifth Circuit Court of Appeals reversed the decision of the Tax Court. While recognizing that the Tax Court's finding was one of fact to which an appellate court would normally defer, the Court of Appeals observed clear error when the Tax Court failed to recognize the following stipulation between the parties: "One of the purposes of Bacchus is to improve tourism, namely the food and entertainment and hotel industries of the city of New Orleans. Mr. Hymel has earned

[27] *Id.*

[1] I.R.C. § 162(a) (1985).

[2] Long v. Comm'r, 277 F.2d 239, 240 (8th Cir. 1960).

[3] 794 F.2d 939 (5th Cir. 1986), *rev'g* 54 T.C.M. (P-H) ¶ 85, 198 (T.C. 1985).

substantial insurance commissions through sales of insurance to members of these industries [who are members of Bacchus] . . . . *Mr. Hymel's income is directly impacted by tourism in New Orleans.*"[4] Since the stipulation established a direct relation between Bacchus and Mr. Hymel's insurance business, the Court of Appeals held that Hymel could properly deduct his membership dues as ordinary and necessary expenses of his insurance business. However, the court stated that it expressed no opinion as to how it would have decided the case in the absence of the "crucial stipulation."[5]

Under Section 162, an expense is ordinary if it is normal, usual, or customary to the particular business, or if it arises from common transactions of that business.[6] Necessary expenses are those that are appropriate or helpful in conducting a business.[7] Expenses are ordinary and necessary to a business if they are of primarily a business nature.[8] Where the expenses are more personal in nature, they are not deductible.[9] The taxpayer has the burden of proving that an expense is of a business, rather than personal nature.[10] An expense is of a business nature if the primary purpose of the expense is to benefit the business.[11] An expense must also be directly related to the business to be an ordinary and necessary business expense.[12] The taxpayer will not meet his burden of proof by arguing that, in general, membership in an organization is helpful in obtaining clients.[13] The taxpayer must prove a more direct relationship than a mere showing that the expense affords contacts with future clients.[14]

In *Randall v. Commissioner,*[15] the Tax Court held that the taxpayer must show more than that he obtained business he would not have obtained if he had not belonged to a club. The Tax Court observed that members of Mr. Randall's country club were clients or potential clients of his law firm. Disallowing deduction of membership dues under Section 162, the Tax Court found these business contacts did not establish that the expenses were primarily for a business purpose or were sufficiently related to Randall's business.[16]

In *Hymel,*[17] the taxpayer supported the deduction of membership dues

[4] *Id.* at 940.

[5] *Id.*

[6] Trebilcock v. Comm'r, 64 T.C. 852, 855 (1975), *aff'd,* 557 F.2d 1226 (6th Cir. 1977).

[7] Welch v. Helvering, 290 U.S. 111, 113 (1933).

[8] Freedman v. Comm'r, 301 F.2d 359, 360 (5th Cir. 1962).

[9] I.R.C. § 262 (1985).

[10] Walliser v. Comm'r, 72 T.C. 433, 437 (1979).

[11] *Id.*

[12] *Id.;* Treas. Reg. § 1.162-1 (a) (1985).

[13] Boehm v. Comm'r, 35 B.T.A. 1106, 1109 (1937).

[14] Henry v. Comm'r, 36 T.C. 879, 886 (1961).

[15] 56 T.C. 869 (1971).

[16] *Id.* at 874-75.

[17] 54 T.C.M. (P-H) ¶ 85, 198 (T.C. 1985).

under Section 162 on the fact that his membership in Bacchus resulted in insurance commissions he otherwise would not have earned. The commissions resulted from insurance policies issued to people he had met through Bacchus. This, Hymel contended, established a direct relation between the membership dues and his insurance business. Hymel also contended that such business contacts were proof that the membership dues were paid primarily in furtherance of a business purpose. The Tax Court, following principles established in the previous line of cases, held that such showings by Hymel fell short of his burden of proof. Where, as here, the expenses are of a traditionally more personal nature, the taxpayer must show more than that he and his customers belong to the same club.[18] The Court of Appeals based its reversal of the Tax Court solely on the stipulation establishing a direct connection between Bacchus and Hymel's insurance business.[19] The court did not overrule the principles established in the previous cases.

Deductibility of "Home Office" Expenses
Meiers v. Commissioner

BLAKE SALAMON

Section 280A of the Internal Revenue Code (Code) provides a general rule which disallows deductions attributable to the business use of a personal residence.[1] However, an exception is made for expenses which are allocable to a portion of the dwelling unit that is exclusively used on a regular basis as the taxpayer's principal place of business.[2] If the taxpayer is an employee, deductions are allowed only if the home office is maintained for the convenience of the employer.[3] Neither the legislative history of Section 280A nor the Code defines "principal place of business." *Meiers v. Commissioner*[4] illustrates the continuing problem which courts face in defining "principal place of business" for purposes of Section 280A.

In *Meiers,* Mrs. Meiers was the manager of a self-service laundromat owned by her and her husband. Her activities included drafting the work schedule for employees and performing bookkeeping and other managerial tasks. She spent an hour per day at the laundromat and two hours per day in

[18] *Id.*
[19] *Hymel,* 794 F.2d at 940.

[1] I.R.C. § 280A(a) (1985).
[2] *Id.* § 280A(c) (1) (A).
[3] *Id.* § 280A(c) (1).
[4] Meiers v. Comm'r, 782 F.2d 75 (7th Cir. 1986), *rev'g* 53 T.C.M. (P-H) ¶ 84,607 (T.C. 1984).

her home office drafting work schedules and doing the laundromat's bookkeeping. The taxpayer's home office consisted of a separate room in their home and was used exclusively for administrative work on behalf of the laundromat. In disallowing the taxpayers' home office deductions, the Tax Court concluded that the taxpayers' laundromat and not their home office was the "focal point" of their business. The Seventh Circuit allowed the deductions and criticized the Tax Court's focal point test. The court reasoned that the focal point test "places undue emphasis upon the location where goods or services are provided to customers and income is generated, not necessarily where work is predominately performed."[5] In determining the taxpayer's principal place of business, the court thought that "a major consideration ought to be the length of time the taxpayer spends in the home office as opposed to other locations."[6]

Prior to the enactment of Section 280A, the Tax Court allowed deductions for home office expenses if such office was "appropriate and helpful" under the circumstances. Congress was concerned that the "appropriate and helpful"[7] test adopted by the Tax Court would result in treating personal expenses which are directly attributable to the home as deductible business expenses.[8] As a result, Congress added 280A to the Code in 1976 to provide "definitive rules relating to deductions for expenses attributable to the business use of homes."[9]

Baie v. Commissioner[10] was the first case after the enactment of Section 280A in which the Tax Court was faced with the job of defining "principal place of business" under Section 280A (c)(1)(A). In *Baie*, petitioner operated a foodstand near her residence. A second bedroom in her home was used exclusively for attending to the records and other paperwork of the foodstand. Her kitchen was used for personal purposes and also to prepare food for the foodstand. The Tax Court concluded that petitioner was not entitled to a deduction for home office expenses because the foodstand, not her home, was the focal point of her activities. In other words, the foodstand was her principal place of business.

In cases similar to *Baie*, the Tax Court has held steadfastly to its focal point test.[11] Under the Tax Court's focal point test, the number of hours spent in different locations is not controlling and the taxpayer's focal point is where income is produced or where goods or services are provided.

[5]*Id.* at 79.

[6]*Id.*

[7]Bodzin v. Comm'r, 60 T.C. 820 (1973), *rev'd*, 509 F.2d 679 (4th Cir.), *cert. denied*, 423 U.S. 825 (1975).

[8]S. REP. NO. 938, 94th Cong., 2d Sess. 4, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579.

[9]S. CONF. REP. NO. 1236, 94th Cong., 2d Sess., *reprinted in* 1976-3 C.B. 807, 839.

[10]Baie v. Comm'r, 74 T.C. 105 (1980).

[11]In Pomarantz v. Commissioner, T.C.M. (P-H) ¶ 86, 461 (T.C. 1986), the Tax Court held that the focal point of an emergency room physician's practice was the hospital and not his home office.

In *Meiers,* the Seventh Circuit relied heavily on *Drucker v. Commissioner*[12] and *Weissman v. Commissioner.*[13] In *Drucker,* three concert musicians set aside a room or part of a room in their apartment which was used exclusively for musical study and practice. The musicians spent thirty hours per week studying and practicing in areas reserved for such use. The Tax Court disallowed the deductions for home office expenses. The Second Circuit reversed and held that the musicians' home practice studios were their principal places of business. The court reasoned that since musicians' employers require so much practice, the focal point of a musician's trade is where he practices, here the home practice studio. In *Weissman,* the Tax Court held that a college professor's principal place of business, for purposes of determining the deductibility of home office expenses, was his college office and not his home office, even though the professor spent 80% of his time researching and writing at his home office. The Second Circuit reversed, and disagreed with the Tax Court's application of the focal point test. The Second Circuit stated that the focal point test places too much emphasis on the place where the taxpayer's work is more visible instead of where most of his work is done.[14]

The Seventh Circuit has joined the Second Circuit in questioning the usefulness of the Tax Court's focal point test. It is not clear whether these two courts have completely rejected the focal point test or whether they merely disagree with the Tax Court's application of the test. It is clear that these two courts apply a more liberal standard than the one applied by the Tax Court. These two circuit courts will give weight to the number of hours spent in different locations. They will not assume that the place where the taxpayer's goods or services are provided and where income is generated is the taxpayer's principal place of business if the facts and circumstances show otherwise. This trend is worth watching as more taxpayers try to meet the provisions of Section 280A.

Charitable Gifts
Stark v. Commissioner

ROXANN T. CONRAD

In *Stark v. Commissioner,*[1] Nelda C. Stark owned a 3,358 acre tract of land in East Texas. In late 1972 and early 1973 the United States Forest

[12]Drucker v. Comm'r, 715 F.2d 67 (2d Cir. 1983), *rev'g* 79 T.C. 605 (1982).

[13]Weissman v. Comm'r, 751 F.2d 512 (2d Cir. 1984), *rev'g* 52 T.C.M. (P-H) ¶ 83, 724 (T.C. 1983).

[14]*Id.* at 514.

[1]86 T.C. 243, 244 (1986).

Service (Forest Service) purchased all but 1,078 acres of the tract for public recreational purposes. Stark wanted the Forest Service to have the entire tract of land for public recreational use and offered to sell the Forest Service the remainder of the land. The Forest Service could not buy the land, however, because The Land and Water Conservation Act of 1965 precluded the purchase of land located outside the existing National Forest boundary. Since Stark did not want to donate the land or exchange it for other Forest Service land, the Forest Service proposed that a third person buy the remaining land from Stark and have the third person exchange the land for other Forest Service property. Stark agreed to the arrangement and to the Forest Service's proposed third person, Harris R. Fender. Stark had never had any prior business or other dealings with Fender.

On April 12, 1972, Stark wrote a letter agreeing to hold 1,000 acres of the tract for sale to Fender until June 1, 1973, as part of the proposed exchange between Fender and the Forest Service. On October 16, 1975, Stark conveyed 77.25 acres of the land to the United States as a donation for no consideration and conveyed 1,001.72 acres of land to Fender for $1,200,000.

Stark, based on a long standing family business practice, retained the interest in all minerals in the land and the right to prospect for, mine, and remove such minerals for 25 years.[2] The reserved mineral rights in the deeds were subject to restrictions to protect the donee and its use of the surface rights. However, at the time of the conveyance there were no known deposits of oil, gas or other minerals on or beneath the land. The nearest property producing oil or gas was 35 miles away and dry holes existed to the north, west, and east of the conveyed land. Further, the hilly terrain of the land was not conducive to the transportation or operation of a drilling rig. At the time of conveyance, the fair market value of the retained mineral interest in the property was between one dollar and two dollars per acre while the fair market value (FMV) of the surface interest in the conveyed land was $1,800 per acre. Stark took a charitable contribution deduction of $139,103 on her 1975 federal income tax return for the 77.25 acres of land donated. She also took a charitable contribution deduction on her 1975 amended return for $536,917.75 and declared a $63,083.35 charitable deduction carryover.[3] This $600,000 deduction was based on the difference between the FMV of the land sold to Fender less the $1,200,000 bargain sale price. The value of the property that Fender received form the Forest Service in the exchange was $1,690,300.[4]

[2] *Id.* at 246.

[3] *Id.* at 248.

[4] *Id.*

Petitioner's Claim		Service's Claim	
FMV of land donated	$139,103.00	FMV of land donated	$139,103.00
FMV of land sold approx.	$1,800,000	Stipulated value of land sold	$1,800,000
Consideration	1,200,000	FMV of Forest Service Land relinquished to Fender	$1,690,300
Charitable contribution deduction	$ 600,000	Charitable contribution deduction allowed	$ 109,700

The Internal Revenue Service (Service) contended that Stark's retention of the mineral interest in the land precluded a charitable contribution deduction with respect to such land. However, the Service asserted that if Stark was permitted a charitable contribution deduction, the amount of the deduction was limited to $109,700 with respect to the land sold. The $109,700 represented the difference between the stipulated value of the surface rights in the conveyed land and the stipulated value of the land received by Fender from the Forest Service.

The issues before the Tax Court were (1) whether Stark's retention of mineral interest in the land precluded any charitable contribution deduction with respect to the land; and (2) if a charitable contribution deduction was permitted, what was the proper amount of the charitable contribution deduction resulting from the bargain sale?

Stark contended that she was permitted a charitable contribution deduction for the donation and bargain sale of her land by Sections 170(a)(1) and 170(c)(1) of the Internal Revenue Code.[5] The Service asserted that the deduction was precluded by Section 170(f)(3)(A) which denied a deduction for contributions of partial interests in property.[6] The Service further asserted that since Stark retained the mineral interests in the land conveyed, there was a conveyance of only a partial interest in the land and therefore Section 170(f)(3)(A) precluded a charitable contribution deduction.

Section 170(f)(3)(B)(ii) provides an exception to the Section 170(f)(3)(A) deduction exclusion. Section 170(f)(3)(B)(ii) permits a deduction for the contribution of "an undivided portion of the taxpayer's entire interest in the property."[7]

Treasury Regulation Section 1.170A-7(b)(1)(i) interprets the Section 170(f)(3)(B)(ii) exception:

> A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an undivided portion of a donor's entire interest in

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[5] *Id.* at 249.

I.R.C. § 170 (a) (1972) Allowance of Deduction. —

(1) General Rule. — There shall be allowed as a deduction any charitable contribution payment of which is made within the taxable year . . .

(c) Charitable contribution defined. — For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of . . .

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

[6] 86 T.C. at 249.

I.R.C. § 170(f)(3)(A) (1972) In general —

In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowed as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer's entire interest in such property.

[7] 86 T.C. at 249.

property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every SUBSTANTIAL interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and other property into which such property is converted.[8]

The Commissioner contended that the mineral rights to the land were a substantial interest. Thus, because of the retention of the substantial interest, there was not a contribution of an undivided portion of an entire interest in the land and no charitable contribution deduction was allowed.[9]

The Tax Court did not rely on Revenue Ruling 76-331 however, and said that Stark did not retain a substantial interest. The court looked first to the test for insubstantiality set out in *E.I. du Pont de Nemours & Co. v. United States.*[10] In *du Pont,* the court said, "To determine whether the taxpayer did transfer all of the substantial rights . . . the key question is whether the transferor retained any rights which, in the aggregate, have substantial value."[11]

Revenue rulings have generally adopted one of two tests for insubstantiality: (1) the Remoteness of Event test; and (2) the Interference with Donee's Use test.[12]

I. REMOTENESS OF EVENT

In Revenue Ruling 77-148, a corporation owned extensive tracts of timberland in the United States.[13] Under a prearranged agreement the corporation deeded a tract of land to an organization whose purpose was to promote the preservation of wilderness areas. The corporation retained a right of reverter of the timber rights if the grantee, at any time during a 90-year period, attempted to sell, or offered for sale, or otherwise disposed of timber of any kind, except in reasonable amounts for the management and enhancement of the property.

Further, the corporation retained the right to explore for and extract any oil or gas on the property. The mineral rights were exercisable only if the Secretary of the Interior specified in writing that the exploration and extraction was "in the national interest," and then only to the extent specified by the

[8] *Id.*

[9] The Commissioner supported his position with Rev. Rul. 331, 1976-2 C.B. 52. In Revenue Ruling 76-331, a corporation donated a tract of land but retained the mineral rights. The ruling omitted any facts as to the value of the land, the value of the mineral rights, and any specific restrictions on the mineral or mining rights. The ruling concluded, however, that the taxpayer had retained a substantial interest or right in the property. Thus, the ruling said that the taxpayer did not donate an undivided portion of its entire interest in the property.

[10] 432 F.2d 1052 (3rd Cir. 1970).

[11] *Id.* at 1055.

[12] Stark, 86 T.C. at 252-53.

[13] Rev. Rul. 148, 1977-1 C.B. 63.

Secretary.[14] At the time of the contribution there were no known deposits of oil or gas on the land.

The Commissioner permitted the taxpayer's deduction and concluded that since the United States planned to use the land as a wildlife preserve, the sale of timber by the United States or the Secretary's permission to explore for minerals was so remote as to be negligible.

In *Stark,* the possibility that the taxpayer would exercise her mineral rights was also negligibly remote.[15] There were no known deposits of any minerals on or under the land. Dry holes existed to the north, west, and east of the conveyed land. Further, the land's hilly terrain was not conducive to the transportation and operation of a drilling rig.

II. Interference with Donee's Use

In Revenue Ruling 75-66 the taxpayer donated 800 acres of land to the United States.[16] The taxpayer retained the right to train his personal hunting dogs on trails extending over the land for the duration of his life. The Department of the Interior informed the taxpayer that his use would not interfere with the Government's use and enjoyment of the land. Thus, the Commissioner said that the retained right was "not substantial enough to affect the deductibility of the property contributed."[17]

In *Stark,* the court found that the retained mineral interest "was subject to substantial restrictions which precluded petitioner's retained interest from ever interfering with the Forest Service's interest."[18]

Thus, since the possibility of Stark exercising her mineral right was so remote as to be negligible, and since substantial restrictions on that right precluded Stark from interfering with the Forest Service's interest, Stark's rights in the land were insubstantial. The court concluded that Stark was allowed a charitable contribution deduction.

The Service contended that Stark was allowed a charitable contribution deduction for the amount by which the Forest Service benefitted ($109,300). The Forest Service benefitted by the difference between the fair market value of the land conveyed by Stark to Fender ($1,800,000) and the fair market value of the land conveyed by the Forest Service to Fender in the exchange ($1,690,300). However, Stark believed that the deduction should equal the full extent of the difference between the fair market value of the land at the time of conveyance (1,800,000) and the value of the consideration received

[14] *Id.*

[15] *Stark,* 86 T.C. at 247.

[16] Rev. Rul. 66, 1975-1 C.B. 85.

[17] *Id.* at 86.

[18] *Stark,* 86 T.C. at 253.

($1,200,000).[19]

The court said, "A taxpayer who makes a bargain sale to charity is typically entitled to a charitable contribution deduction equal to the difference between the fair market value of the property and the amount realized from the sale."[20] However, the court said that this was true only if Stark "made the bargain sale 'to or for the use of' the United States and 'for exclusively public purposes.'"[21] The court said that Stark must have intended the Forest Service to benefit and not herself or some other nonqualified person, in order to deduct the entire $600,000 from the bargain sale.

The court further stated that Stark's actual motivation was not entirely clear. However, Stark sold the land to Fender only at the Forest Service's request. In fact, Stark had initially offered to sell the Forest Service the land. In addition, Stark had no knowledge of the value of the land that the Forest Service conveyed to Fender in the exchange. The court said that any reasonable person who intended to confer a benefit on another would presume that the benefactor "would accept such benefit and not divert a substantial part of it to a third party."[22] The court concluded that Stark did not intend to benefit Fender by $490,300, and thus should not be limited in her deduction by such an amount based on a lack of donative intent.

The Tax Court concluded that Stark was allowed a charitable contribution deduction even though she retained mineral interests in the land. Further, Stark was allowed a charitable contribution deduction for $600,000, representing the difference between the fair market value of the land at the time of the conveyance and the amount of consideration received.

State Law and Charitable Gifts
Hartwick College v. United Staes

PENELOPE TAYLOR

The United States Court of Appeals for the Second Circuit recently took a firm position[1] in upholding the policy that statutes authorizing deductions for charitable contributions would be liberally construed. Charitably motivated gifts are encouraged and continue to receive favorable income tax treatment.

[19] *Id.* at 255.
[20] *Id.* at 256.
[21] *Id.*
[22] *Id.* at 257.

[1] Hartwick College v. United States, 801 F.2d 608 (2d Cir. 1986).

Jessie Smith Dewar died testate on May 28, 1976, leaving an estate of $49 million.[2] Her will provided that all of the debts, expenses and taxes were to be paid from the general estate.[3] Then, after specific bequests were made to named beneficiaries, the residuary estate would be divided among five named charitable organizations.[4]

After paying nearly $34 million in administrative expenses and taxes, insufficient funds were left in the estate to fully pay even all of the non-residuary beneficiaries.[5] The estate did not claim a charitable deduction on its federal fiduciary income tax return (Form 1041) because the executors believed that no residuary estate for the charities would be left after the administrative costs and taxes were paid.

The charities themselves filed an amended income tax return for the estate and requested a refund. The Service failed to act so the charities brought suit. United States District Court for the Northern District of New York[6] determined that the testatrix, by naming the charities in the residuary clause without any conditions or contingencies, had permanently set aside[7] the amount of income that would constitute the residuary estate.[8] Accordingly, the estate was entitled to a charitable deduction in the amount that the residuary beneficiaries would have received.[9]

The Dewar estate had earned $2.4 million in income during 1976 and 1977, the tax years in question.[10] One million had been spent on nondeductible administrative expenses and was considered taxable income.[11] The estate was in the 70% tax bracket.[12] The district court determined that the pre-tax amount of $1.4 million was the appropriate basis for the charitable deduction.[13]

On appeal, the Second Circuit affirmed.[14] After establishing proper jurisdiction,[15] the Second Circuit moved to the heart of the issue: whether an

[2] *Id.* at 609.

[3] *Id.* at 610.

[4] Three of the named beneficiaries, Hartwick College, Aurelia Osborn Fox Memorial Hospital Society and Railroad and Local Young Men's Christian Association of Oneonta, New York, brought the suit.

[5] *See* Hartwick College v. United States, 611 F.Supp. 400-01 (N.D.N.Y. 1985).

[6] *See* Hartwick College v. United States, 588 F.Supp. 926 (N.D.N.Y. 1984).

[7] *Id.* at 930-31. The availability of the deduction was based upon the testatrix's intent to make the gift rather than on "which came first," the residue or the tax. *Id.*

[8] *Id.* at 931 and *Hartwick College,* 611 F.Supp. at 401.

[9] *Id.* The estate was entitled to an income tax deduction under I.R.C. § 642(c) (1977) permitting deductions for amounts paid or permanently set aside for a charitable purpose. The plaintiffs qualified as charitable organizations under I.R.C. § 170(c) (1977).

[10] *Hartwick College,* 611 F.Supp. at 402.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 404-05. The government also alleged on appeal that the charities were not proper parties to file for a refund. However, the Second Circuit relied on Rev. Rul. 366, 1973-2 C.B. 408. *See infra* note 15.

[14] *Hartwick College,* 801 F.2d 608.

[15] *Id.* at 612-13. Jurisdiction required an authorized party to duly file a tax return on behalf of the estate. *See*

interrelated computation or a straight deduction method should be used to calculate the charitable deduction.

The government argued that the "interrelated computation" method was appropriate.[16] Its position was that no deduction for the charitable donation could include money used to pay taxes.[17] The estate had taxable income of $1 million and, at the 70% tax bracket, a tax of $700,000 was incurred. If the charitable deduction is decreased, more taxable income results. The government asserted that the donation could be no more than was actually donated.[18] This logic results in the eventual total elimination of any charitable deduction.[19]

The charities argued that the deduction amounted to $1.4 million, the government receiving $700,000 (70% of the $1 million taxable income) and the remaining $700,000 to charity.[20]

The government offered little authority for its method of calculation.[21] Basically, it was attempting to apply estate tax rules to the calculation of income taxes. The Second Circuit refused to extend that approach without a showing of specific congressional intent.

Instead, the court upheld the prevailing policy of liberally construing statutes created to provide deductions for charitable giving.[22] The longstanding view has been to encourage people to make such contributions.[23] If the Service were permitted to use its pyramid technique of calculating deductions and the related taxes due, little if anything would remain to pass to the charitable residuary beneficiaries.

Two further reasons were offered for the court's position in favor of the charities.[24] First, the amount of revenues lost by the Service is small compared

I.R.C. § 7422(a) (1977). Rev. Rul. 366, 1973-2 C.B. 408 permits someone other than the taxpayer's legal representative to file a claim for credit. A residuary legatee is a proper party to file such a claim. *Id.*

[16] *Hartwick College,* 801 F.2d at 613.

[17] *Id.*

[18] *Id.*

[19] *Id.* at 614. The court clarified in a footnote that since at least $700,000 had to be used to pay for the tax on the non-deductible administrative expenses and that the deduction could not include money used or to be used to pay taxes, the resulting deduction could not exceed the $700,000 remaining in the estate after taxes were paid. However, under the government's theory, since the deductions had to be reduced from $1.4 million to $700,000 an additional $700,000 of taxable income would be exposed. This resulted in $490,000 of additional taxes to be paid, 70% of the newly exposed income. Therefore, since the deduction could not include money needed to pay this additional tax liability, the resulting deduction could not exceed $210,000. Finally, this deduction in the actual charitable donation would expose another $490,000 of income to taxation and result in the total elimination of any charitable deduction.

[20] *Id.* at 613.

[21] The government relied on the Revenue Act of 1924, ch. 234, § 303(a)(3), 43 Stat. 253. The estate tax provision, I.R.C. § 2055(c) (1977), requires that charitable amounts previously set aside be reduced by the actual amount of estate taxes paid. However, the income tax provisions contain no parallel requirement.

[22] *Hartwick College,* 801 F.2d at 616.

[23] Hilvering v. Bliss, 293 U.S. 144, 150-51 (1934).

[24] *Hartwick College,* 801 F.2d at 616.

to the size of the estate and the related estate taxes. Second, it is not possible for a testator to plan and minimize the tax burden on estate income. Estate administration expenses alone deplete a large portion of an estate. Both of these reasons justify different treatment of the estate itself and the estate's income.

Unless the Service is successful in appealing this case, beneficiary charities will enjoy favorable income tax treatment as residuaries of estates. Donors can also feel more certain that their charitable intent will be fulfilled.

Personal Holding Company Tax
Kenyatta Corp. v. Commissioner

JAMES COMODECA

Congress enacted the personal holding company tax in 1934 to eliminate the misuse of the corporate entity.[1] The personal holding company concept was developed after Congress realized that the accumulated earnings tax was often useless since the "specific intent" element was usually impossible to prove. Specifically, a showing of an intent to avoid taxes must be proven to impose the accumulated earnings tax.[2] On the other hand, the personal holding company tax applies whenever a corporation satisfies two objective tests.

Unlike the "subjective test" applied in the accumulated earnings tax situation, the personal holding company tax is imposed automatically when both the "tainted income"[3] test and the "stock ownership"[4] test are satisfied. In *Kenyatta Corp. v. Commissioner,*[5] the Tax Court found the corporation to be a personal holding company and, therefore, subject to the personal holding company tax in addition to the regular tax.

I. BACKGROUND

Kenyatta Corporation was specifically formed to provide the personal services of retired basketball star Bill Russell. The corporation entered into con-

[1]*See* Kurt Frings Agency, Inc. v. Comm'r, 42 T.C. 472 (1964), aff'd 351 F.2d 951 (9th Cir. 1965) (per curiam). The personal holding company tax was established to end the "professional talent" loophole where people such as athletes, movie stars and musicians set up corporations offering their services. Subsequently, the corporation would be paid and the actor or athlete would be paid substantially less than the revenue earned. The result was that most of the money earned was taxed at the lower corporate rate.

[2]I.R.C. § 532(a) (1978) General Rule — The accumulated earnings tax imposed by Section 531 shall apply to *every corporation* . . . formed or availed of for the purpose of *avoiding* the income tax . . . (emphasis added).

[3]*See* Kenyatta Corp. v. Comm'r, 86 T.C. 171 (1986) and I.R.C. § 542(a)(1) (1978) which states, "At least 60 percent of its adjusted ordinary gross income (as defined in Section 543(b)(2)) for the taxable year is personal holding company income (as defined in Section 543(a)) . . ."

[4]I.R.C. § 542(a)(2) (1978) Stock Ownership Requirement — At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, indirectly or directly, by or for not more than five individuals . . ." *See also Kenyatta Corp.*, 86 T.C. at 181-82.

[5]*Id.*

tracts with such companies as ABC Sports, the Seattle Times, Seattle Supersonics and Cole & Weber, all specifically designating Russell as the man to perform the services.[6] These contracts totalled approximately $94,000 in revenues that would be taxed at a corporate rate but for the personal holding company tax. Obviously, Russell would save thousands of tax dollars if he were allowed to shelter his money in the lower tax-based corporation.

In *Kenyatta Corp.*, the main issue was whether during 1978 the corporation was a personal holding company within the meaning of Section 542(a).[7] After examination of Kenyatta Corporation's 1978 tax returns, it was found to be a personal holding company and therefore subject to the Section 541 tax.[8]

II. PERSONAL HOLDING COMPANY — TWO PART TEST

A. *"Tainted Income" Test*

In general, at least 60% of a personal holding company's income (PHCI) must be derived from personal service contracts or other types of services to trigger personal holding company status. Section 542(a)(1) more specifically states that at least 60% of a corporation's adjusted ordinary gross income must be considered personal holding income to impose the tax.

Therefore, to adequately determine whether or not the 60% threshold is met, one must compute the (1) gross income; (2) ordinary gross income; and (3) adjusted ordinary gross income (AOGI).[9] Once the AOGI has been determined, it is compared to the personal holding company income to determine if the 60% threshold has been satisfied.

In *Kenyatta Corp.* the court found the AOGI to be $138,895.[10] Additionally, the court concluded that $93,728.35 was personal holding company income derived via personal service contracts.[11] Since $93,728.35 exceeded 60% of AOGI, Kenyatta Corporation satisfied the first prong, the "tainted income" test, of the two prong test.[12]

The $93,728.35 was determined to be personal holding company income

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[6] *Id.*

[7] I.R.C. § 542(a)(c) (1978) specifically exempts certain types of corporations from the personal holding company tax. Corporations which are not subject to this tax include tax exempt corporations under subchapter F, life insurance companies, surety companies, lending institutions, foreign personal holding companies and others.

[8] I.R.C. § 541 (1978) states "In addition to other taxes imposed by this chapter there is hereby imposed for each taxable year . . . tax equal to *50 percent* of the undistributed personal income." (emphasis added)

[9] I.R.C. § 543(b) (1978). This section specifically sets out what is necessary for a proper computation of adjusted ordinary gross income.

[10] *Kenyatta Corp.*, 86 T.C. at 189.

[11] *Id.*

[12] *Id.* In other words, the personal holding company income divided by the adjusted ordinary gross income must be greater than or equal to 60% of the adjusted ordinary gross income. Since $93,728.25 divided by $138,895 is approximately 67.5%, Kenyatta Corporation satisfied the "tainted income" test.

(PHCI) pursuant to Section 543(a)(7). This section applies to all situations where a corporation is to provide personal services and:

(1) The person to perform is "designated" in the contract; or
(2) Any person, other than the corporation, has the right to "designate" the person to perform the services.

The $93,728.35 was earned through contract with ABC Sports, the Seattle Times, Seattle Supersonics, and Cole & Weber, which all specifically designated Bill Russell as the person to perform the services. The specific designations, combined with Kenyatta Corporation's subsequent lack of power to substitute another to perform, resulted in the income earned to falling within the scope of Section 543(a)(7) PHCI.[13] Additionally, before income is considered PHCI it must be shown that the "designated" person (Russell) owned 25% or more of the outstanding stock anytime during the year.

If the "stock ownership" test set-out below is met, then the Section 543(a)(7) augmented stock requirement is satisfied also. Upon proper review, the Tax Court determined that both stock tests were met in *Kenyatta Corp.*

B. *Stock Ownership Test*

The stock ownership test of Section 542(a)(2) is satisfied if at any time during the last half of the year, more than 50% of the corporation's outstanding stock is owned by five or less people.[14] Closely-held corporations are obviously vulnerable to the tax. Any corporation with less than ten shareholders will always satisfy this test.

Kenyatta Corporation was just such a closely-held corporation, vulnerable to the tax. Kenyatta Corporation argued that it did not satisfy the stock ownership test (via Bill Russell's interest) because no stock had ever been issued. Unfortunately, the issuance of stock is not the determinative factor for purposes of stock ownership pursuant to Section 542(a)(2).[15] Evidence revealed that Russell was intended to be the majority stockholder and was designated by the corporation as the holder of all of the voting stock.

Therefore, Kenyatta Corporation satisfied the "stock ownership" test necessary for imposition of the personal holding company tax. Also, the augmented stock test concerning Section 543(a)(7) personal service contracts was satisfied.

[13] I.R.C. § 543(a)(7) (1978). *See also* Rev. Rul. 67, 1975-1 C.B. 169, where a corporation's primary source of income was from a doctor. Although the doctor owned 80% of the stock, the Service determined that the issue was whether the patients specifically "designated" the doctor, thereby making the income personal holding income. The Service held that the income was not personal holding income because the services were not so unique as to prohibit the corporation from substituting another doctor. Although the Service noted the patients' implied "designations," it also found that the corporation was not bound to provide any specific doctor's services. *See also* Rev. Rul. 250, 1975-1 C.B. 179.

[14] *Kenyatta Corp.*, 86 T.C. at 181-82.

[15] *See* Collateral Equities Trust v. Comm'r, 39 B.T.A. 834, 839-40 (1939).

Unitary Taxation and Multinational Corporations

MARY ELLEN KOLLMAN

The problem of unitary taxation[1] continues for multinational corporations (MNCs), especially those based in the United States. California recently passed legislation giving water's edge treatment[2] as an option for MNCs. Other options based on a water's edge approach are still being considered by Congress, but no action has yet been taken. As a result, the burden of unitary taxation still exists for MNCs operating in the United States.

On September 5, 1986, California passed legislation giving affiliated groups of banks or corporations an election for a form of water's edge apportionment instead of their present world-wide unitary taxation.[3] If MNCs opt for water's edge treatment, they must pay an annual election fee and must accept water's edge treatment for 10 years. If eligible for the election, water's edge apportionment will affect:

1) Affiliated banks or corporations eligible for a federal consolidated return;
2) Domestic International Sales Corporations;
3) Foreign Sales Corporations;
4) Export Trade Corporations;
5) Domestic banks and corporations which are controlled 50% or more by the same interests;
6) Other banks and corporations to the extent of income derived from or attributed to domestic sources; and
7) Controlled foreign corporations with Subpart F income.[4]

With this election, 75% of qualifying dividends received from 80/20 companies[5] with more than 50% control by the taxpayer are excludable from the taxpayer's income. In some cases, qualifying foreign dividends may have a portion that is 100% excluded from taxable income.

California's legislation came in response to the report from the Worldwide Unitary Taxation Working Group which assembled in 1983 to discuss the controversial issue of unitary taxation imposed by many states.[6] The purpose of

[1]Unitary taxation is a method of taxing affiliated groups of corporations that ignores the legal separateness of the corporations insofar as they carry on a "unitary" business. Stevenson, *California's Unitary Reform: A Step Forward,* 39 TAX EXECUTIVE 135, 135 (1987).

[2]The "water's edge" approach is a unitary method that excludes all foreign-source income and foreign allocation factors from the unitary tax base. *See Final Report of Unitary Tax Working Group Filed,* 62 TAXES 678 (1984) [hereinafter *Final Report*].

[3]CAL. REV. & TAX CODE § 25110 (West 1986).

[4]*Id.* § 25110(a) (West 1986).

[5]80/20 companies are companies that are based in the United States that do 80% or more of their business abroad. *See* Stevenson, *supra* note 1, at 144.

[6]*See Final Report, supra* note 2, at 679.

the group was to present a recommendation to President Reagan concerning the future of unitary taxation. The Working Group generated six options for unitary taxation based on the "water's edge" approach.

The first option is an alternate activities tax in lieu of unitary apportionment. This option allows foreign-based MNCs to elect a tax based on their in-state business activities, such as payroll, property, and sales. This proposal still does not resolve the unitary taxation problem regarding taxing domestically-based MNCs and the objections by foreign governments concerning the taxes paid by foreign-based MNCs.

With the second option, comprehensive water's edge is combined with taxation of foreign dividends, without the gross-up of foreign taxes computed for the federal foreign tax credit. Thus, the state members of the Task Force presented a taxation method in which foreign- and domestically-based MNCs would be treated in the same manner. However, business members disagree. They argue that, with full taxation of cash dividends from foreign subsidiaries and with foreign-based MNCs only being taxed on income from domestic operations, domestically-based MNCs are being subject to discrimination. Therefore, this proposal would place domestically-based MNCs at a competitive disadvantage on a worldwide level.

Also, presented by the state members is the third option, comprehensive water's edge combined with taxation of foreign dividends, with factor relief from the gross-up of foreign taxes computed for the federal foreign tax credit. According to the state members, this option is supposed to handle both domestically- and foreign-based MNCs identically for tax purposes. With this method, dividend income, including what the firm has paid in foreign taxes, is included in the state's tax base. This results in double taxation of income which domestically-based MNCs never receive. The same argument for option two concerning the competitive disadvantage of domestically-based MNCs still exists for option three.

The fourth option, modified water's edge combined with exclusion of foreign dividends, was drawn up by business members of the Task Force. Proponents of this option state that the competitive edge between domestic and foreign-based MNCs would be equal since states would tax both only on their domestic operations. Opponents argue that, with the exclusion of foreign dividends, the loss of state revenue will place a greater burden on domestic, smaller firms — thus, discriminating against them. This method also includes a recommendation for making settlements on retroactive claims under the option.

Also suggested by the business members is the fifth option, modified water's edge combined with special "foreign income" rule. With this rule, "the taxable income of the combined water's edge group would be reduced by a "foreign income component" consisting of dividends, interest, royalties, etc. received from foreign affiliates. Then, a minimum level of domestic-source income would be established for the state's basis of taxation. The business members state that this option will keep the competitive position among domestically- and foreign-based MNCs since it does not include pre-tax foreign income in the state's tax basis. Similar to the arguments against option four, opponents of option five reason that foreign investment through the use of the special "foreign income" rule would lower state revenue. In addition, the state tax burden will be shifted toward the smaller, domestic firms.

The final option, comprehensive water's edge combined with non-discriminatory treatment of intercorporate dividends, was presented by the Advisory Commission on Intergovernmental Relations.[7] Using this alternative, an equivalent method of taxing foreign and domestic dividends would be developed by each state. Whether or not this option would benefit or discriminate against domestically-based MNCs will be determined by the individual state's method of taxing dividends.

Even though no uniform proposal was reached, the final report of the Worldwide Taxation Working Group was presented to President Reagan on August 31, 1984. In addition to the six options, the report included three principles upon which the state, business, and federal representatives all agreed. The three principles, which should be represented in each state's taxation policies, are:

1) A water's edge unitary combination for both domestically- and foreign-based companies under certain conditions;
2) Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and
3) Competitive balance for domestic and foreign MNCs and purely domestic businesses.[8]

Although the principles and options may appear ideal in theory, they will require extraordinary costs to implement. Furthermore, the biggest area of disagreement, the taxation of foreign dividends and 80/20 corporations was left unresolved, so each state could decide for itself how to deal with these issues.

Although the proposed federal legislation to prohibit unitary taxation was introduced in December, 1985, Congress has not enacted any bill, and California's recent bill may or may not relieve the pressure over unitary taxation. Thus, the issue will eventually be resolved in the renegotiating of tax treaties if Congress or state legislatures do not better alleviate the problem of applying unitary tax apportionment methods to MNCs.

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[7] *Id.*
[8] *Id.* at 678.

Tax Consequences of AT&T divestment Dunn Trust v. Commissioner

ANNE G. MCBRIDE

The Justice Department's longstanding antitrust suit which culminated in the break up of American Telephone and Telegraph (AT&T) produced an unfortunate and unexpected side effect for AT&T shareholders. Pursuant to a plan of divestiture and reorganization stemming from the suit, AT&T divested itself of its regional holding companies, which included stock in the PacTel Group,[1] and the Bell Operating Companies.[2] In 1981, AT&T formed a new wholly owned subsidiary, Pacific Transmission, which was merged into Pacific Telephone and Telegraph Company (Pacific), one of the Bell Operating Companies. Since AT&T did not acquire "control" of Pacific within the meaning of Internal Revenue Code (Code) Section 368(c), the merger was taxable to the Pacific shareholders who now held AT&T stock. In May 1982, Pacific merged into AT&T, becoming one of AT&T's subsidiaries. In 1983, the Internal Revenue Service (Service) allowed AT&T to amend the Pacific merger plan to qualify as a tax free reorganization[3] under Section 368(a)(1)(E), thus no gain or loss was recognized to those former Pacific shareholders. The twenty-two operating companies, which included Pacific, formed the seven regional holding companies. In the reorganization, Pacific became Pacific Telesis (PacTel).[4]

Before the reorganization, AT&T held all the stock in Pacific, this was transferred with other assets in the reorganization to PacTel for voting stock in that company. The result was that PacTel held all the Pacific stock, the original Pacific shareholders held AT&T stock, and AT&T held PacTel Group stock. AT&T then distributed the PacTel stock to its shareholders. The Edna Louise Dunn Trust, administered by Morgan Guaranty Trust as Trustee, held 400 shares of AT&T stock entitling it to receive a distribution of PacTel Group stock. The Service's ruling that the PacTel stock distribution was taxable affected millions of individuals, corporations and institutional shareholders, including the Dunn Trust.[5]

On the surface, the Service's position was not unreasonable. The Service argued that the Pacific stock was somehow "dressed up" as PacTel stock and

[1]Dunn Trust v. Comm'r, 86 T.C. 745 (1986).

[2]*See id.* at 747.

[3]*See* I.R.C. § 368(a)(1)(D) (1984) (presumably the section qualifying the transfer as tax free and imposing the I.R.C. § 355(a)(3)(B) limitation). *But see* I.R.C. § 368(a)(2)(B) (1984).

[4]Pacific, and thus PacTel, had 21,430,000 shares of cumulative preferred stock (aggregated) and 224,504,982 shares of common stock issued and outstanding. 1 Moody's Investor's Service, Public Utilities Manual 218 (1983). AT&T itself had 849,550,000 shares of common stock and 26,552,719 shares of cumulative preferred stock (aggregated) issued and outstanding. *Id.* at 130.

[5]*Dunn Trust*, 86 T.C. 745.

therefore that portion of PacTel stock attributable to the earlier Pacific holdings were taxable distributions of "other property." The parties stipulated that the fair market value of the Pacific stock was $.39 per share of AT&T.[6] One share of each of seven holding companies (one of which was PacTel) was distributed for every ten shares of AT&T held by AT&T shareholders. Each share of PacTel Group stock had a stipulated value at time of distribution equal to $.39 per share of AT&T stock. Therefore, the 40 shares of PacTel received by the Dunn Trust triggered a taxable property dividend of $156 (each share of PacTel Group distributed for every 10 shares of AT&T constituted a taxable property dividend of $3.90).

The Tax Court held that the distribution was not taxable, by reason of Section 355(a)(3)(B).[7]

Section 355(a)(1)(A) and (D) allows a corporation to distribute to its shareholders solely "stock . . . which it controls immediately before the distribution . . . and no gain or loss shall be recognized to . . . such shareholder." Since AT&T did not own any Pacific stock immediately before the distribution, all it could (and did) distribute was PacTel stock which it had acquired in a tax free transaction.

After a thorough discussion of the legislative intent and history of Section 355, the court remarked in closing that the Service attempted to have the court do what Congress might have done if an example of such a transaction had come to its attention.[8] The AT&T shareholders who had included the distribution in income were thus entitled to a tax refund.

The case appears innocuous at first glance. For individual shareholders, the amount of taxable dividends was not large enough to warrant challenge. Institutional holders, particularly in fiduciary capacities, are not themselves directly impacted; most trustees err on the side of conservatism and would not bring an action for such small amounts. Apparently the Service counted on taxpayers deciding tax payment was cheaper than a suit, even "on principal." When the Tax Court ruled against the Service, the Service did not establish an automated refund program. Rather, each individual taxpayer must file an amended return. For those taxpayers who do not prepare their own returns, the additional cost of a preparer could exceed the refund.

The myriad of changes in the tax laws over the past ten years have left the case law in a state of flux and many taxpayers floundering in the Service's wake. Practioners and private individuals need to be alert to emerging interpretations of as yet unsettled law, and new twists to seemingly settled areas. No area, no matter how small the amount or issue, is immune from the Service's attack.

[6] *Id.* at 751.

[7] Of the seven regional holding companies and other Bell Operating companies engaged in transfers in divestiture, only the PacTel Group transfer was held taxable.

[8] *Dunn Trust,* 86 T.C. at 751-55.

Customer Payments to Utility Companies Gas Light Co. of Columbus v. Commissioner; and Yankee Atomic Electric v. United States

TED N. KAZAGLIS

Each year utility companies receive payments from customers which are not exclusively in return for goods or services. *Gas Light Co. of Columbus v. Commissioner*[1] and *Yankee Atomic Electric v. United States*[2] are two cases which demonstrate two possible situations where the issue of the includability of payments in income could arise. The courts have applied two methods to categorize these deposits: 1) the primary purpose test and 2) the assignment of income doctrine.

In *Gas Light Co. of Columbus* the Tax Court considered the issue of whether customer deposits received by the utility company are includable in income as prepayment for goods and services.[3] In finding the deposits to be income, the court applied the primary purpose test.

The Gas Light Co. of Columbus (Petitioner) is an intrastate public utility company. The Petitioner's primary business is the sale of natural gas to residential, commercial, and industrial customers. During 1971, 1972, 1973, and 1975 the Petitioner required customer deposits from any customer who did not have an established credit record with the Petitioner. The Petitioner required the deposits in order to insure payment of the customer's final bill of account. The deposits were carried on Petitioner's books as a liability, not as income. As the Petitioner received deposits, they were deposited in a general bank account, thus commingling the customer deposits with Petitioner's other funds. Until the Petitioner was required to refund the deposits to the customers, access to and use of the deposits was unlimited.

The Petitioner contended that the deposits were not includable in income because:

1) deposits were only required from 40% of the customers;
2) deposits were only required for customers who lacked a credit rating; and
3) deposits were refunded after 24 months of prompt payments.

On the other hand, the Internal Revenue Service (Service) contended that the deposits were includable in income because their primary purpose was prepayment for goods and services. Furthermore, the Service contended that

[1] 55 T.C.M. (P-H) ¶ 86,118 (T.C. 1986).

[2] 782 F.2d 1013 (Fed. Cir. 1986).

[3] 55 T.C.M. (P-H) ¶ 86,118.

the customer deposits were advance payments[4] relating to inventoriable goods. Therefore, the income had to be recognized no later than the last day of the second year following the receipt of the advanced payments.[5]

The Tax Court followed the Eleventh Circuit decision in *City Gas Co. of Florida v. Commissioner*[6] which considered the issue of includability of customer deposits in income. The Eleventh Circuit Court stated that deposits to utility companies often serve mixed purposes:

1) prepayment for goods and services; and
2) as security for the performance of nonincome-producing covenants.[7]

If the primary purpose, under all circumstances, is the prepayment of income items, the payment is includable in gross income under Section 61(a).[8] However, if the primary purpose is to secure performance of non-income-producing covenants, the payment is not taxable.

The Tax Court in *Gas Light Co. of Columbus* relied upon the following facts in applying the primary purpose test and thus requiring the deposits to be included in income:

1) the deposit was required in order to insure payment of the customer's final bill;
2) the deposit receipt which the customer signed when making a deposit contained an agreement which stated the deposit was security for the performance of the contract of service or could be applied against the customer's account;
3) the deposit receipt did not mention whether the deposit could be applied against any property damage or any other nonincome-producing covenant;
4) Petitioner testified that they applied deposits to reduce charge-off of uncollectible final bills; and
5) Petitioner applied deposits towards unpaid final bills.[9]

From these facts the Tax Court concluded that the primary purpose of the customer deposits was securing prepayment of goods and services, thus categorizing the deposits as income. Furthermore, based upon *City Gas Co. of Florida v. Commissioner,*[10] the court rejected the Petitioner's contentions of why the deposits were not income. Specifically, the fact that the deposits were subject to refund,[11] the Petitioner treated the deposits as liabilities on their

[4]As defined in Treas. Reg. § 1.451-5(a) (1975).

[5]Pursuant to Treas. Reg. § 1.451-5(c) (1975).

[6]689 F.2d 943 (11th Cir. 1982).

[7]An example of such a case would be where a utility company requires a customer to deposit a sum as security against damage to the rented premises and agrees to refund the deposit in full if no such damage occurs.

[8]I.R.C. § 61(a) (1975).

[9]55 T.C.M. (P-H) ¶ 86,118.

[10]689 F.2d 943.

[11]The Eleventh Circuit Court of Appeals in *City Gas Co. of Fla.*, 689 F.2d at 946 concluded that the possibility of refund was not in and of itself enough to exclude customer deposits from income.

books,[12] and Petitioner's right to retain the deposits were contingent[13] and were not sufficient to exclude the deposits from income.

In *Yankee Atomic Electric Co. v. United States,* the Federal Circuit Court of Appeals addressed the issue of whether customer payments to a trust, wholly independent of the company, were income to the company.[14] In order to answer this question the Court had to first decide whether the assignment of income doctrine applied.

The Yankee Atomic Electric Co. (Company) was an owner and operator of an atomic generating facility. The customers of the Company were various utilities who supplied power to consumers. The bills from the Company to its customers were rendered in two parts. The first payment went to the Company for power furnished at a regulated rate. The second payment went directly to a trust. The trust corpus was to be accumulated to $30,000,000 to recompense the Company for the anticipated high cost of decommissioning the nuclear facility.[15] Until the time of decommissioning, the Company did not have access to or control over the trust corpus. When decommissioning occurred any surplus of the fund over the decommissioning costs would be refunded to the customers.

The Government contended that the payments to the trust were still the taxpayer's income and must be taxed as such, under the assignment of income doctrine. On the other hand, the Company claimed a refund of income taxes paid was due because the Company erroneously reported amounts paid by customers to the trust, which the Company did not actually earn.

The assignment of income doctrine was first enunciated in *Lucas v. Earl,*[16] which stated that income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of the income.

In finding the payments to the trust were not income, the court in *Yankee Atomic Electric Co.* concluded that the assignment of income doctrine did not apply since the Company would not earn the amounts paid into the trust unless and until the facility was decommissioned.[17] Furthermore, even if the plant was decommissioned, the Company might not earn all of the money

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[12]The Tax Court stated that it was bound by the Eleventh Circuit's decision in *City Gas Co. of Fla.,* 689 F.2d at 949, which specifically rejected this argument. 55 T.C.M. (P-H) ¶ 86,118.

[13]*Id.*

[14]782 F.2d 1013.

[15]Decommissioning is the process by which a nuclear power plant is removed from service. Federal and state laws require utilities that operate nuclear power plants to decommission them at the end of their useful lives; it is necessary for safety since the plant would be dangeroulsy radioactive. A decommissioning fund is a segregated reserve dedicated exclusively to the payment of decommissioning costs, taxes on fund income, and management costs of the fund. I.R.C. § 468A(e)(4) (1975).

[16]281 U.S. 111 (1930).

[17]782 F.2d at 1015.

since any deposits in excess of decommissioning costs would be refunded to the customers. Therefore, any payments out of the fund would be taxable when paid if paid to the Company. The court summarized its position by stating the assignment of income doctrine could not be applied to a taxpayer in cases of escrow to fund future performance since the taxpayer has not actually earned the income.[18]

Since the Federal Circuit's decision in *Yankee Atomic Electric Co.,*[19] the Service has issued Temporary Regulations regarding the income tax treatment of nuclear decommissioning costs.[20] Taxpayers engaged in the furnishing or sale of electric energy generated by a nuclear power plant are now required to include in gross income the amount of nuclear decommissioning costs that are included in cost of service for rate making purposes for any taxable year.[21] Furthermore, amounts payable to any other entity (such as a trust or state government) shall be treated as if payable to the taxpayer.[22] Thus, the amount of decommissioning costs directly or indirectly charged to the customer of a utility company is required to be included in the company's gross income.

Additionally, the Service has provided an elective method for taking into account nuclear decommissioning costs for federal income tax purposes.[23] In general, an eligible taxpayer that elects the application of Section 468A is allowed a deduction for the amount of cash payments made to a nuclear decommissioning fund during any taxable year.[24] Furthermore, the regulations under Section 468A set-out:

1) those taxpayers eligible for the election;
2) the limits to the amount deductible;
3) the manner of making the election;
4) the nuclear decommissioning fund qualification requirements; and
5) the effective date of Section 468A.[25]

Thus, payments to utility companys which include deposits for items other than goods and services are categorized as income or expenses under the primary purpose test. Where the power is being generated by a nuclear power plant, any deposits received by the company with respect to decommissioning costs shall be regulated by Section 468A and not the assignment of income doctrine.

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[18]*Id.* at 1016.

[19]782 F.2d 1013.

[20]Temp. Treas. Regs. 1.88-1T and 1.468A-1T-8T (1975).

[21]Temp. Treas. Reg. 1.88-1T (1975).

[22]*Id.*

[23]Temp. Treas. Reg. 1.468A-1T-8T (1975).

[24]*Id.*

[25]*Id.*

Corporations as Agents
Bollinger v. Commissioner

JON DERHODES

Individuals or partnerships often form corporations in order to obtain financing for construction projects at rates that would be usurious if charged to the individuals or partnerships. Such corporations are taxable entities because they are formed for the legitimate business purpose of obtaining financing.[1] However, these corporations may escape taxation if they are agents of the individuals or partnerships.[2]

In *Bollinger v. Commissioner,*[3] Jesse C. Bollinger formed a corporation in order to obtain financing for the construction of apartment complexes. Bollinger was the sole shareholder. He and the corporation entered into an agreement which provided that the corporation would hold title to the apartment complexes as an agent of Bollinger for the sole purpose of obtaining financing. The corporation executed loan agreements and transferred the funds to Bollinger who paid all costs of construction. As soon as feasible following completion of construction, the corporation would convey title to Bollinger. Bollinger sought none of the benefits of doing business in the corporate form. He held himself liable for all expenses of construction. Bollinger employed people to run the apartments, execute leases, collect rents, and keep records. Bollinger also was involved as a partner in several other apartment developments. Corporations were formed, as above, solely to obtain financing. In all of these arrangements, the lenders considered Bollinger or the partnerships to be the owners, sought personal guarantees from them and looked to them for repayment. None of the corporations had any liabilities, assets, employees, or bank accounts. All income and losses from the apartment projects were reported by Bollinger and the partners on their individual income tax returns. The Internal Revenue Service (Service) denied attribution of income and losses to Bollinger and the partnerships, holding such income and losses to be those of the corporations which held title to the real estate. The Tax Court held that Bollinger and the partnerships clearly established that the corporations were acting as agents, and the income and losses were attributable to Bollinger and the partnerships.[4]

On appeal, the Sixth Circuit affirmed the Tax Court. In deciding for the taxpayer, the Sixth Circuit took a view of the test set out by *National Carbide Corp. v. Commissioner*[5] that opposed the views adopted by the Fourth Circuit

[1] Moline Properties, Inc. v. Comm'r, 310 U.S. 436, 438-39 (1943).

[2] National Carbide Corp. v. Comm'r, 336 U.S. 422, 437 (1949).

[3] 807 F.2d 65 (6th Cir. 1986).

[4] Bollinger v. Comm'r, 53 T.C.M. (P-H) ¶ 84,560 (T.C. 1984).

[5] 336 U.S. 422.

in *Ourisman v. Commissioner*[6] and the Fifth Circuit in *Roccaforte v. Commissioner.*[7] The Supreme Court in *National Carbide* stated six factors to consider in determining whether a corporation is a non-taxable agent of an individual or partnership. Those factors are:

1) Whether the corporation operates in the name of the principal;
2) Whether the corporation binds the principal by its actions;
3) Whether the corporation transfers money received to the principal;
4) Whether receipt of income is attributable to services of employees and assets of the principal;
5) Whether the corporation's relationship with its principal is independent of the fact it is owned by the principal; and
6) Whether the corporation's business purpose includes the normal duties of an agent.[8]

The Sixth Circuit in *Bollinger* felt that the first four factors, which are generally recognized attributes of an agency relationship, showed that an agency relationship existed.[9] The court viewed the fifth and sixth factors as inquiring whether the corporate nominee acts no differently than an independent agent would act.[10] Where a corporation performs acts that an independent agent would also perform, an agency relationship is established. The Sixth Circuit determined that such acts as holding nominal title and transmitting funds to Bollinger and the partnerships were acts that an independent agent would normally perform.[11] Therefore, the court held, the facts satisfied the test of *National Carbide.*

Under facts substantially similar to *Bollinger,* the Fourth Circuit in *Ourisman,* and the Fifth Circuit in *Roccaforte,* determined that corporations used to obtain financing were not agents.[12] Despite meeting the first four tests of *National Carbide,* which showed attributes of an agency relationship, the taxpayers in *Ourisman* and *Roccaforte* failed to show that the corporations' relations to their principals were not dependent on the fact that they were owned by the principals.[13] The Fourth and Fifth Circuits view the fifth factor as mandatory and more important than the other factors.[14] If the attributes showing an agency relationship are present solely because the principal controls the corporation, the relationship is merely a "manifestation of the underlying corporation-shareholder relationship and . . . the corporation

[6]760 F.2d 541 (1985).

[7]708 F.2d 986 (1983).

[8]*Nat'l Carbide,* 336 U.S. at 437.

[9]*Bollinger,* 807 F.2d at 68.

[10]*Id.* at 69.

[11]*Id.*

[12]*Ourisman,* 760 F.2d at 548; *Roccaforte,* 708 F.2d at 990.

[13]*Ourisman,* 760 F.2d at 547-48; *Roccaforte,* 708 F.2d at 989-90.

[14]*Ourisman,* 760 F.2d at 547; *Roccaforte,* 708 F.2d at 989.

therefore must be regarded as a separate taxpaying entity . . ."[15] The Fourth and Fifth Circuits felt that the essential inquiry is whether the corporation and the individual or partnership are dealing at arms-length.[16] Where there is no relationship based on arms-length bargaining, the relationship arises solely out of the control which the principal has over the corporation and is not a true agency relationship. The Fourth Circuit noted in *Ourisman* several considerations for determining if an arms-length arrangement exists:

1) Whether an identity of ownership interests in the principal and agent exists;
2) Whether the corporation's articles of incorporation specifically limit corporate purposes so that the corporation may act only as an agent;
3) Whether the agent acts for more than one principal;
4) Whether the agent entered into a written agency contract setting forth its duties and providing for reasonable compensation; and
5) Whether the agent collected reasonable compensation.[17]

If these questions are answered in the negative, the arrangement is not made at arms-length and the corporation is regarded as a separate taxable entity.[18]

The Sixth Circuit's interpretation of the *National Carbide* test is the same as that taken by the Tax Court.[19] These courts focus on what the corporate nominee is doing in determining whether an agency relationship exists. If the corporation acts no differently than an independent agent, regardless of the principal's control of the corporation, the corporation is a true agent and non-taxable.[20] The Fourth and Fifth Circuits would inquire further into the acts of the corporation to see why attributes of agency exist. If the corporation would not perform such acts unless the individual or partnership controlled the corporation, the corporation is not a true agency, but merely arises out of the normal corporation-shareholder relationship.[21] The taxpayer must show the agency exists independent of such ownership and control.[22]

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[15] *Ourisman*, 760 F.2d at 549.

[16] *Ourisman*, 760 F.2d at 548; *Roccaforte*, 708 F.2d at 990.

[17] *Ourisman*, 760 F.2d at 548.

[18] *Id.*

[19] *E.g.*, Roccaforte v. Comm'r, 77 T.C. 263 (1981); Ourisman v. Comm'r, 82 T.C. 171 (1984); *Bollinger*, 53 T.C.M. (P-H) ¶ 84,560.

[20] *Bollinger*, 807 F.2d at 69.

[21] *Roccaforte*, 708 F.2d at 990.

[22] *Id.*

Equal Treatment for College Fraternities? Zeta Beta Tau Fraternity, Inc. v. Commissioner

CATHY PASTORE

In November of 1986, the Tax Court struck a blow for equal treatment under the law. As a result, America's taxpayers will no longer be subsidizing the operations of college fraternities. In the case of *Zeta Beta Tau Fraternity,*[1] the court determined that the favorable status of "domestic fraternal society"[2] was not applicable to college fraternities and sororities; instead, they are classified as "social clubs."[3] Although the difference in semantics is slight, the tax ramifications will be severe because investment income of college fraternities and sororities is now subject to taxation at regular corporate rates.[4]

Section 501 of the Internal Revenue Code sets forth a list of exempt organizations.[5] Generally tax exempt organizations described in Section 501 are taxed at regular corporate rates on unrelated business income.[6] The term "unrelated business taxable income" is defined in Section 512 (a). Certain items normally thought of as business income are excluded from the income of tax exempt organizations.[7] A special definition of unrelated business taxable income is provided for tax exempt social clubs as described in Section 501(c) as found in section 512(a)(3)A.[8] The result of this separate definition of "unrelated business taxable income" is that investment income of Section 501(c)(7) social

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[1] 87 T.C. 421 (1986).

[2] I.R.C. § 501(c)10 (1985).

[3] *Id.* § 501(c)7.

[4] *Id.* § 512(a)(3)A.

[5] I.R.C. § 510(c) provides in pertinent part:

> (7) Clubs organized for pleasure, recreation and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which ensures to the benefit of any private shareholder.
>
> (10) Domestic fraternal societies, orders or associations operating under the lodge system —
> (A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and
> (B) which do not provide for the payment of life, sickness, accident, or other benefits.

[6] I.R.C. § 511(a) (1985).

[7] The court in *Zeta Beta Tau Fraternity, Inc.*, defined unrelated business taxable income as the gross income derived from any unrelated trade or business regularly carried on by an organization less allowable deductions that are directly connected with the conduct of the trade or business. The court found that under 152(b), generally, investment income such as dividends, interest, annuities, royalties, rents derived from real property, and capital gains are excluded from the exempt organization's unrelated business income.

[8] I.R.C. § 512(a)(3)(A) provides:

> In the case of an organization described in Section 501(c)(7) or (9) the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income . . .

Section 512(b) defines exempt function income as "the gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization."

clubs is taxed as unrelated business income, whereas, investment income of Section 501(c)(10) fraternal organizations is excluded from taxation by definition.[9]

In *Zeta Beta Tau,* the fraternity sought to be qualified as both a Section 501(c)(7) social club and a Section 501(c)(10) fraternal benefit society so as to avoid taxation on its investment income. The IRS denied the claim based on Treasury Regulation 1.501(c)(10)-1. The regulation states: "any organization described in Section 501(c)(7) such as, for example, a national college fraternity, is not described in Section 501(c)(10) . . ."[10] The court relied primarily on legislative history in finding that Regulation 1.501(c)10-1 was reasonable, and that national fraternities are properly classified under Section 501(c)(7) as social clubs.[11]

It appears that *Zeta Beta Tau* does fit within a literal reading of Section 501(c)(10) in that it is a fraternal society operating under a lodge system[12] which does not provide insurance benefits to its members, and is exclusively for educational and fraternal purposes. Nevertheless, granting it tax exempt status for the purposes of the unrelated business tax would not fit within the spirit of the law.[13] Social clubs were initially given a tax exempt status because:

> Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate activity. The funds exempted are received only from the members, and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another both within the same pair of pants.[14]

Since the predominant purpose of college fraternities is to provide housing, board and social services for its undergraduate student members, investment income is likely to be used for these purposes. Allowing such income to go untaxed would provide an unintended benefit to these members. This was a result that was not intended by Congress in enacting Section 501(c)10.[15]

The court's holding in *Zeta Beta Tau Fraternity, Inc.* was clearly in accord with congressional intent. The court's determination that a college frater-

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[9]*See Zeta Beta Tau Fraternity, Inc.*, 87 T.C. at 224-87. *See also* South End Italian Independent Club, Inc. v. Comm'r, 87 T.C. 168 (1986).

[10]*Exempt College Fraternity Taxable on Investments,* Journal of Taxation, 440 (December 1986).

[11]*Id.*

[12]The term "operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters or the like." *Zeta Beta Tau Fraternity, Inc.*, 87 T.C. at 187-224.

[13]*Id.* at 225.

[14]*Id.* (citing McGlotten v. Connally, 338 F. Supp 448, 458 (D.D.C. 1972).

[15]*Id.* (quoting S. COMM. REP. NO. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 423, 440).

nity's purpose was different from the purpose of a fraternal organization, such as the Masons, provided a reasonable basis for treating the two organizations differently. Thus the court properly upheld Treasury Regulation 1.501(c)10 and prohibited Zeta Beta Tau, Inc. from obtaining its tax exempt status under Section 501(c)10.

Taxation of Testamentary Trusts
Bedell v. Commissioner

LISA AFARIN

In *Bedell v. Commissioner,*[1] the Tax Court addressed the issue of whether a testamentary trust, consisting largely of a family business, is properly taxable as a trust or classified as an association taxable as a corporation. The court held that the testamentary trust did not have "associates" and could not be classified as an "association" taxable as a corporation.

Harry M. Bedell, Sr. died in 1964. In his will he bequeathed his personal effects to his wife and devised a life estate in the family home to her. Bedell gave the residuary of his estate to the Harry M. Bedell, Sr. Trust for the benefit of his wife and children. The trust consisted of the remainder interest in the family home, a summer home, a filling station and the assets of the Bedell Manufacturing Company.[2]

The children were appointed as trustees and were directed to continue to operate the company "as long as [the trustees] . . . find it advisable and profitable."[3] The trustees were directed to manage the property as a trust fund to "invest and reinvest the same."[4] Bedell left no instructions regarding transferability of interests by beneficiaries. However, the Tax Court found "the testator's emphatic efforts in various parts of the will to make sure benefits of the estate were to inure only to his blood descendants . . . strongly suggest[ed] an intention that the beneficial interests were to remain within the family."[5]

The beneficiaries annually paid full taxes on their share of trust income. Shares of income were determined by reference to Bedell's will, not in accordance with capital contributions.

In 1980 and 1981, the trust filed form 1041 "U.S. Fiduciary Income Trust Return" reporting both as taxable income and as income distribution deduction the profit from the Bedell Manufacturing Company and rental income

[1] 86 T.C. 1207 (1986).

[2] *Id.* at 1208.

[3] *Id.*

[4] *Id.* at 1210.

[5] *Id.*

from the remaining property in the trust.[6]

The Commissioner determined that the Bedell Manufacturing Company, administered by the estate of Harry M. Bedell functions as an association and should be taxed as a corporation, therefore the income distribution deduction was disallowed.

The court cited *Morissey v. Commissioner*[7] as the starting point for determining whether the trust qualified as an "association" for tax purposes. *Morrisey* set out six specific criteria to determine the status of a given entity. The six criteria are: "i) associates, ii) an objective to carry on business and divide the gains therefrom, iii) continuity of life, iv) centralization of management, v) liability for corporate debts limited to corporate property, and vi) free transferability of beneficial interests.[8]

Since four of the six criteria are generally characteristic of both trusts and associations the determinative criteria as to whether an entity is classified as a trust or association is 1) whether there are associates, and 2) an objective to carry on business and divide the gains therefrom.[9]

The court cited the literal interpretation of the regulations in *Larson v. Commissioner*[10] and applied a literal application to the subject case.

Both criteria of "associates" and "objective to carry on business and divide gains" must be present and the organization must have "more corporate characteristics that non-corporate characteristics"[11] in order to be classified as an association.[12] The court found that the Bedell trust did not have "associates" and failure to satisfy this test alone precluded classification as an "association."

The definition of "associate" was not met in this case because the beneficiaries did not make a common effort to conduct a business enterprise.[13] They did not affirmatively enter into the enterprise by a purchase of their beneficial interests.[14]

The court cited other factors that lead to its determination of "trust" classification. The drafting of the will and trust documents illustrated the decedent's strong desire to keep the beneficial interests in the trust within his family. The clear intentions of the decedent were that the beneficial interests of the trust only be available to children and grandchildren of the whole blood and

[6] *Id.* at 1211.

[7] 296 U.S. 344 (1935).

[8] 86 T.C. at 1216 (citing Morrissey v. Comm'r, 296 U.S. 344, 357 (1935)).

[9] 86 T.C. at 1217.

[10] 66 T.C. 159 (1976).

[11] 86 T.C. at 1216 (citing Section 301.7701 - 2(a)(3), Proced. & Admin. Regs.).

[12] *Id.*

[13] *Id.* at 1219 (citing *Morrisey*, 296 U.S. at 357 (1935)).

[14] *Id.* (citing Elm Street Realty Trust v. Comm'r 76 T.C. 803, 814 (1981).

not freely transferable to other parties. Only three of the original ten beneficiaries maintained any control over the trust property. "Participation in trust management by so few beneficiaries does not transform all beneficiaries to associates and the trust into an association."[15]

In a final note, the court stated that this case should not be regarded as authority that no testamentary trust may be classified as an association.[16] Since no single element was determinative of the result, the court made its decision based on the aggregate facts. The court found it regrettable that the IRS pursued this case as a "test case" for testamentary trusts engaged in the conduct of a business as the facts of the case made it an unsuitable vehicle for legal precedent.[17]

When a Tax Court Decision Becomes Final
Abatti v. Commissioner

JACKIE OWEN

In *Abatti v. Commissioner,* the Tax Court reaffirmed that its decisions become final 90 days after a judgment is entered unless the petitioners appeal pursuant to I.R.C. § 7481.[1] Although the Tax Court has recognized two judicial exceptions to this rule, neither applied in *Abatti.*[2]

The petitioners filed a motion in Tax Court on February 18, 1986, for leave to file motion to vacate decisions.[3] They were limited partners in five California limited partnerships formed for the purpose of leasing property and mining for coal. These partnerships formed a joint venture (Boone Powellton Coal Partners, Ltd.) on the same day they were formed. The joint venture contracted on behalf of the partnerships with a coal company to mine coal in West Virginia. The partnerships executed subleases on December 31, 1976, with the coal company. The subleases provided that the limited partnerships would pay an advanced minimum royalty to the coal company. Each of the taxpayers joined the partnership after November 20, 1976, and before December 31, 1976.

Each chose the calendar year as its tax year and the accrual method of ac-

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[15]86 T.C. at 1221.

[16]*Id.*

[17]*Id.*

[1]86 T.C. 1319 (1986). *See generally* Kutner v. Comm'r, 245 F.2d 462 (7th Cir. 1956); Lasky v. Comm'r, 235 F.2d 97 (9th Cir. 1956), *aff'd,* 352 U.S. 1027 (1957).

[2]The court stated it had the power to set aside a decision which would have been final, if "fraud on the court" could be proved or if it was based on mutual mistake. *Abatti,* 86 T.C. at 1319.

[3]*Id.* This motion was filed pursuant to Rule 162, Tax Court Rules of Practice and Procedure. *Id.*

counting. For 1976 each partnership reported advanced royalty losses with the taxpayers claiming deductions for their distributive shares. The Commissioner denied the deductions and the taxpayers petitioned the Tax Court for review.[4]

A group of 113 taxpayers signed agreements to be bound by the Court's opinion in the lead case.[5] The court held for the Commissioner in a partial summary judgment in the lead case decisions and entered decisions in all the cases which were subject to the agreement.[6]

Thereafter, fifty-one cases which were subject to the agreement appealed within the proper time.[7] On September 9, 1985, the Court of Appeals reversed and remanded *Gauntt* in *Heinz v. Commissioner.*[8] The opinion held a one sentence legal conclusion: "Taxpayers were not given a full and fair opportunity to ventilate the issues involved in the motion."[9] The petitioners in *Abatti* did not appeal the decisions entered against them.[10]

Section 7481 of the Internal Revenue Code states that a Tax Court decision becomes final in ninety days, unless it is appealed.[11] Once a decision is final, it cannot usually be attacked.[12] However, the court has jurisdiction to set aside a decision that would otherwise be final if "fraud on the court" is shown[13] or when it is founded on mutual mistake.[14]

First, the petitioners claimed that all the parties to the agreement intended to be bound by the final decision in the lead case.[15] Since some of the taxpayers appealed and their cases were reversed and remanded, their decisions were not final. Therefore, the petitioners claimed theirs was not final either.[16] The Tax Court responded, "In effect, they argue that the agreement provides them with all the benefits of an appeal without incurring the expense and without com-

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[4] *Id.*

[5] *Id.* The lead case was Gauntt v. Comm'r, 82 T.C. 96 (1985) *rev'd* and remanded sub nom. Heinz v. Comm'r, 770 F.2d 874 (9th Cir. 1985), *rev'd and remanded in an unpublished order sub nom.* Alexander v. Comm'r, (9th Cir. 1986). In part, the agreements stated:

> 5. The parties intend that the trial of the five consolidated cases be determinative of all the issues relating to the five partnerships, with respect to all of the petitioners subject to this agreement.
>
> 6. b. That all of the subject cases will be bound by this Court's opinion in the five consolidated cases listed above, and decisions may be entered in accordance therewith.
>
> c. That all of the subject cases except the five consolidated cases listed above will be continued generally until such time as an opinion is issued with respect to the consolidated cases. *Abbatti,* 86 T.C. at 1321.

[6] *Id.* at 1319.

[7] *Id.*

[8] 770 F.2d 874 (9th Cir. 1985).

[9] *Id.* at 876.

[10] *Abatti,* 86 T.C. 1319.

[11] I.R.C. § 7481 (1985).

[12] *Abatti,* 86 T.C. at 1319.

[13] Toscano v. Comm'r, 441 F.2d 930 (9th Cir. 1971), *vacating* 52 T.C. 295 (1969).

[14] Reo Motors v. Comm'r, 219 F.2d 610 (6th Cir. 1955).

[15] *Abatti,* 86 T.C. at 1325.

[16] *Id.*

plying with the statutory procedural requirements."[17]

The court disallowed their contention and looked to the agreement signed by the parties. The agreement referred only to the trial in the Tax Court. "It did not affect the rights and duties of the petitioners to appeal their cases individually."[18] This was supported by the fact that fifty-one of the 113 taxpayers subject to the agreement appealed their decisions. Also, the petitioners themselves did not object within ninety days of when motions for entry of decision on their cases were filed.

The petitioners also argued that failure to enforce their interpretation of the agreement amounted to fraud on the court. The court rejected this argument stating that to prove fraud on the court, "the petitioners must show that an intentional plan of deception designed to improperly influence the Court in its decision has had such an effect on the Court."[19] When the Tax Court entered the decisions, they were in express accord with the agreement as already shown and no fraud was involved.

In effect, the petitioners wanted all the benefits of an appeal without going through all the time and expense involved. The Tax Court would not allow this.

The agreement stated that "the subject cases will be bound by this Court's opinion" and referred in one part to "this trial."[20] It referred only to that particular trial of the lead case and did not bind the parties to the agreement for any subsequent appeals.

As the court pointed out, if the parties had wanted to, they could have written the agreement so that they would only be bound by the final decision in the lead case.[21] The decisions in the subject cases would not be entered until the final decision in the lead case, whether at the trial court level or at the appeals level. The taxpayer would then get the benefit of an appeal without the attendant burdens.

Grand Jury Materials and Tax Liability
Caprio v. Commissioner

AGATHA MARTIN WILLIAMS

Rule 6(e) of the Federal Rules of Criminal Procedure allows the disclosure of grand jury materials at a court's discretion when the materials are related to

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

a current or impending judicial proceeding. However, the Supreme Court recently held in *United States v. Baggot* that grand jury materials cannot be used to determine civil tax liabilities because such use is not "preliminary to . . . a judicial proceeding."[1] The Court left open the question of whether the *Baggot* rule should be given retroactive effect.

In *Caprio v. Commissioner,*[2] the Third Circuit Court of Appeals was faced with just such a dilemma — to determine whether grand jury materials obtained and used by the Internal Revenue Service (Service) to assess Caprio's tax liability were protected by *Baggot.*[3] The court held that even with the retroactive effect of *Baggot,* the evidence did not need to be suppressed.[4]

Frank Caprio was sole shareholder and officer of two companies that became the subject of a New Jersey federal grand jury investigation. The companies were allegedly involved in a scheme to defraud the City of Newark. Subsequently, Caprio testified before the grand jury and pleaded guilty to one count of filing a false 1969 federal income tax return for one of the companies.[5]

At the close of the grand jury's investigation, the United States Attorney was granted an order authorizing disclosure to the Service of the matters before the grand jury for use in determining the civil tax liabilities of Caprio and his wife.[6] The Service sent deficiency notices to the Caprios on July 29, 1977. Subsequently, the taxpayers challenged these notices in Tax Court.

On June 30, 1983, with the Caprios' challenge still pending, the Supreme Court decided *Baggot.*[7] On August 10, 1984, the Caprios moved in Tax Court to suppress the grand jury materials on the ground that *Baggot* should be applied retroactively.[8] However, the motion was denied. Eventually, the Caprios reached an agreement with the Service and stipulated to the true amount of back taxes owed. The Caprios, however, reserved the right to appeal the Tax Court's denial of their motion to suppress.

The Third Circuit affirmed the decision of the Tax Court without examining the retroactivity question.[9] The court affirmed on the theory that the grand jury material was essential to the finding of back tax liability. Further, the court reasoned that the material was obtained in a good faith reliance on the district court's 1977 order and suppression of such evidence was not a proper remedy.

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[1] United States v. Baggot, 463 U.S. 476 (1983).

[2] 787 F.2d 109 (3rd Cir. 1986).

[3] 463 U.S. 476.

[4] *Id.*

[5] 787 F.2d 109.

[6] *Id.*

[7] 463 U.S. 476.

[8] 787 F.2d at 110.

[9] *Id.* at 111.

Previously, the Supreme Court in *Peltier v. Commissioner*[10] considered the appropriateness of suppressing evidence from a warantless border patrol search that would have been invalid under a subsequent Supreme Court decision. The Court held that the evidence should not be suppressed because the officers reasonably believed in good faith that their search was legal under the state of the law as they found it. The Court said suppression would neither deter future misconduct nor promote judicial integrity.[11]

In *United States v. Leon,*[12] police officers obtained a facially valid warrant and used it to execute a search upon which an arrest was made. The district court held the warrant invalid because the affidavit used to obtain it was insufficient to establish probable cause. The court nonetheless held that the evidence should not be suppressed because the marginal benefits of suppression were outweighed by the substantial costs of exclusion.

In *Cohen v. Commissioner,*[13] the Service commenced an audit of the Flamingo Company. The case was later turned over for criminal investigation because of allegedly suppressed income. Ultimately, grand jury indictments were issued against Cohen and others but were later dropped. The Service then reopened the case in order to assess tax liability and used the grand jury material without application of a Rule 6(e) order. The court reasoned that the Service intentionally and flagrantly violated grand jury secrecy and granted the taxpayer's motion to suppress the evidence. Also, the court granted the motion to shift the burden of going forward with the case to the Service.

In yet another case the Third Circuit agreed with *Baggot.* In *Graham v. Commissioner,*[14] the United States Attorney filed a motion under Rule 6(e) seeking to disclose matters which would enable the Service to determine the Graham's tax liability. The disclosure was challenged on the basis that *Baggot* applied retroactively. The court concluded that even if *Baggot* applied retroactively, the rationale of *Leon* mandated that suppression was not a proper remedy.[15]

Even when applied retroactively, the suppression of evidence is not necessarily mandated under *Baggot.* Good faith reliance and a facially valid order by a district court are strong factors used to ultimately determine if suppression is appropriate. These decisions, excepting *Cohen,* represent a departure from the rule in *Baggot. Caprio* shows the Third Circuit's willingness to preserve the judicial process and deter future misconduct by the Service by making sure the Service is within the ambit of Rule 6(e) when using grand jury

[10] 422 U.S. 531 (1975).

[11] 422 U.S. at 537-39.

[12] 104 S. Ct. 3405 (1984).

[13] 50 T.C.M. (P-H) ¶ 81,901 (T.C. 1981).

[14] 770 F.2d 381 (3rd Cir. 1985).

[15] *Id.* at 385.

material to assess tax liability.[16]

A taxpayer whose case was pending before *Baggot* was decided must be able to show that the conduct of the Service reflected negatively on the good faith of an investigation and was an abuse of judicial process. Then evidence can be suppressed.[17]

Availability of Attorneys Fees in Tax Cases
Kaufman v. Egger

CYNTHIA DAVIS

Absent statutory authority, attorney fees are generally not revoverable in tax cases. However, Congress has passed three statutes which permit recovery of these fees and costs: The Civil Rights Attorney Fees Act of 1976,[1] The Equal Access to Justice Act (EAJA)[2] and Section 292 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[3]

The Civil Rights Attorney Fees Act applies only if the United States brings the suit.[4] In most cases, this precludes recovery by a taxpayer since the taxpayer is usually the plaintiff. The Equal Access to Justice Act has been used by plaintiff taxpayers, but this Act was specifically revised by TEFRA and codified as Internal Revenue Code (Code) Section 7430 which allows recovery of costs in Tax Court. Actions must be brought under Section 7430, where it applies, rather than the EAJA.[5] The Tax Reform Act of 1986 (TRA 86) extends the life of Section 7430 to specifically assure taxpayers an opportunity to recover litigation fees.

Section 7430 was included in TEFRA and TRA 86 to permit a prevailing party to recover reasonable litigation fees in civil proceedings against the United States. This section was designed under TEFRA to apply only to cases which commenced after February 23, 1983,[6] but before December 31, 1985,[7] and recovery was limited to $25,000.[8] In addition to the time and dollar limita-

[16]787 F.2d at 111.

[17]*See* Gluck v. United States, 771 F.2d 750 (3rd Cir. 1985).

[1]Pub. L. No. 94-559, 90 Stat. 2641 (1976) (amending 42 U.S.C. § 1988).

[2]Pub. L. No. 96-481, §§ 201-08, 94 Stat. 2321 (1980) (codified as 5 U.S.C. § 504 and 28 U.S.C. § 2412).

[3]Pub. L. No. 97-248, Stat. 324, 572 (1982) (codified as I.R.C. § 7430 (1976)). This section was retroactively reinstated and modified by § 1551(f) of the Tax Reform Act of 1986 (TRA 86).

[4]Pub. L. No. 99-514, § 1551, 100 Stat. 2085 (1986) (codified as I.R.C. § 7430 (1986)).

[5]*Id.*

[6]I.R.C. § 7430(f) (1985).

[7]*Id.*

[8]*Id.* § 7430(b)(1).

tions, the party filing for the recovery of reasonable litigation costs had to be the prevailing party,[9] must have exhausted all of the administrative remedies available,[10] and must have established that the Internal Revenue Service (Service) took an unreasonable position which caused the taxpayer to seek recourse in court.[11]

TRA 86 retroactively reinstated Section 7430 thus extinguishing the time barrier and removing the $25,000 limitation on awards, replacing this limit with a $75 per hour maximum subject to court adjustment.[12] The Service's unreasonable position requirement has been replaced by a "not substantially justified" position standard. TRA 86 also enlarged the scope of the Code beyond the court proceedings to include government mishandling once an action reaches the District Counsel level[13] but denies recovery if "the prevailing party has unreasonably protracted such proceeding."[14] In addition, a new net worth ceiling is introduced with TRA 86 based on the "requirements of Section 504(b)(1)(B) of Title 5 as in effect on October 22, 1986 . . ."[15]

To be a prevailing party, the taxpayer must establish that the Service's position was "not substantially justified (unreasonable under TEFRA) and the taxpayer must substantially have prevailed in the civil proceeding either as to the amount in controversy or the most significant issue or set of issues presented."[16] If the parties do not agree who the prevailing party is, the court will make the determination.[17]

Taxpayers are required to exhaust all available administrative remedies unless the court determines that such a requirement is unnecessary.[18] It should be a factual matter as to whether a party has exhausted the administrative remedies available. For example, in *Kaufman v. Egger,*[19] the Kaufman's did not receive a 1978 statutory notice of deficiency as required by Section 6212 because they had moved to another state in 1979.[20] The Service seized a refund due to them in 1982 to collect on the 1978 deficiency. The Kaufman's filed for injunctive relief in district court. The Service later conceded their error and the case was settled. Consequently, the Kaufman's filed to recover fees associated with the equitable relief and won.

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[9] *Id.* § 7430(a).

[10] *Id.* § 7430(b)(2).

[11] *Id.* § 7430(c)(2)(A)(i).

[12] I.R.C. § 7430(c)(i)(A)(ii)(II) (1986).

[13] *Id.* § 7430(c)(4).

[14] *Id.* § 7430(b)(4).

[15] *Id.* § 7430(c)(2)(A)(iii).

[16] *Id.* § 7430(c)(2)(A)(i).

[17] *Id.* § 7430(c)(2)(A)(ii)(I), (II).

[18] *Id.* § 7430(b)(1).

[19] Kaufman v. Egger, 584 F. Supp. 872 (D. Me. 1984).

[20] *Id.* at 874.

The district court found that since the Kaufman's did not receive notice of the deficiency early enough to allow administrative remedies, they should not be penalized because of an error outside their control.[21] The court noted that Congress enacted Section 7430 to "enable taxpayers to vindicate their rights regardless of their economic circumstances"[22] and that Congress did not intend the IRS "to escape liability for the legal expenses they caused Plaintiffs to incur merely because they admitted, after the civil case had commenced . . . their conduct had been consistently wrong."[23]

The most difficult element in determining if a taxpayer can collect attorney fees under Section 7430 is whether or not the Service has taken a substantially unjustified or unreasonable position given the facts and circumstances of each case. In *Powell v. Commissioner,*[24] the taxpayers were challenged on their right to deduct certain losses associated with a limited partnership. The Service changed its position after the petition was filed. The taxpayer prevailed and was awarded attorney fees. The Service contended that its litigation position was reasonable and the taxpayer should be barred from recovering costs. The Fifth Circuit Court of Appeals held that both the prelitigation position and litigation position should be scrutinized in determining reasonableness, because it is the former which causes the taxpayer to seek protection in court.[25]

Once the threshold requirements of Section 7430 are met, the final element to be considered is the determination of reasonable attorney fees and costs. Kaufman found these expenses included reasonable court costs, expert witness expenses, costs of studies, reports and tests necessary for preparing for litigation and the reasonable expenses paid or incurred for the services of attorneys in connection with the action.[26] Congress has stated that the costs can be proven by affadavits submitted to the court, stating actual time expensed and the hourly rate applied.[27]

Courts have full discretion in awarding costs under Section 7430. Congress intended that Section 7430 stop the Service's abuses and allow all taxpayers, regardless of their economic status, to "vindicate their rights."[28]

Although TEFRA Section 7430 was originally intended to expire after 1985, TRA 86 breathed new life into the section which allows taxpayer recovery of litigation costs. However, TRA 86 "modifies Section 7430 to con-

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[21] *Id.* at 879-80.

[22] *Id.* at 878 (citing H.R. REP. NO. 404, 97th Cong., 2d Sess. (1982)).

[23] *Id.* at 879-80.

[24] Powell v. Comm'r, 791 F.2d 385 (5th Cir. 1986).

[25] *Id.*

[26] *Kaufman,* 584 F. Supp. at 880.

[27] *Id.*

[28] *Id.* at 879.

form it more closely to the Equal Access to Justice Act."[29]

Consequently, the EAJA limitations on net worth are now effective for tax cases, but unlike the EAJA, the taxpayer, not the Government, must prove that the government's actions were substantially unjustified. Congress has continued to recognize the need to protect the individual taxpayer from the powers of the federal government.

[29] S. REP. NO. 313, 99th Cong., 2d Sess. 198 (1986).