

July 2015

Federal Income Tax Developments: 1978

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(1979) "Federal Income Tax Developments: 1978," *Akron Law Review*: Vol. 12 : Iss. 2 , Article 1.

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FEDERAL INCOME TAX DEVELOPMENTS: 1978

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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1978 is the sixth of an annual series of articles to be published in the *AKRON LAW REVIEW*. The scope of this survey is limited to the substantive developments in the field of income taxation. The thrust of this article is not only to identify new developments, but also to trace these concepts through their formulative changes.

Given the volatile nature of taxation, it is crucial for the practitioner in this field to remain current with the changes which have occurred during the year. Research of this article includes cases decided through January 1, 1979. The Revenue Act of 1978 will be covered in the winter issue of the *AKRON LAW REVIEW*.

In an attempt to minimize the lead time between research and publication, this author has engaged the most able assistance of several members of the *AKRON LAW REVIEW*. Without their substantial contributions and complete dedication, this article would not have been possible. The author, therefore, wishes to recognize and thank the following members of the *AKRON LAW REVIEW*, for their efforts in researching, writing and compiling this article: Timothy D. Carnahan, Gregory L. Petersen, Linda L. Robison, Michael P. Swanson and Michael R. Stith.

TABLE OF CONTENTS

Paragraph

- 1.00 Income**
- 1.01 Meal Allowances
- 1.02 Net Gift
- 1.03 Scholarship
- 1.04 Deferred Compensation
- 1.05 Tuition Fees — Payments by Employer
- 1.06 Severance Payments
- 1.07 Deferral of Farm Income

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- 2.00 Exclusions**
- 3.00 Exemptions**
 - 3.01 Dependency Exemption—Children of Divorced Parents
- 4.00 Deductions**
 - 4.01 Medical Expense—Capital Improvements
 - 4.02 Medical Expense—Disability Insurance Premiums
 - 4.03 Medical Expense—Laetrile
 - 4.04 Research and Development Expenses
 - 4.05 Medical and Charitable Deductions—Credit Cards
 - 4.06 Illegal Rebates and Discounts
 - 4.07 Hedge Agreements—Unreasonable Salary
 - 4.08 Deduction for Estate Taxes—I.R.D.
 - 4.09 Interest—Loans on Insurance Policy
 - 4.10 Education Expense
 - 4.11 Business Expense—Rental Expenses
 - 4.12 Sale and Leaseback Arrangement
- 5.00 Tax Credits**
- 6.00 Depreciation**
- 7.00 Gains and Losses**
 - 7.01 Capital Gains—Installment Sales
- 8.00 Procedure**
 - 8.01 Bankruptcy Reform Act of 1978
 - 8.02 Suits Against the IRS
 - 8.03 Jury Awards
 - 8.04 Duties of Tax Return Preparers
 - 8.05 Elimination of District Conference
 - 8.06 Summons—Third Party Records
 - 8.07 Summons—Attorney-Client Privilege
- 9.00 Inventory**
- 10.00 Pension, Profit-Sharing and Stock Ownership Plans**
- 11.00 Corporations**
 - 11.01 Brother-Sister Corporations
 - 11.02 Unreasonable Accumulation of Earnings—
Bardahl Formula Questions
 - 11.03 Gift of Corporate Stock Followed by a Redemption
 - 11.04 Type A Reorganization—Continuity of Interest
 - 11.05 Section 337 Liquidation—Type C Reorganization

12.00 Subchapter S Corporations

12.01 Capital Gains—Section 337 Liquidation

1.00 Income

1.01 Meal Allowances

Two major questions concerning the taxability of meal allowances have been answered in recent Supreme Court decisions: 1) whether or not Section 119¹ allows exclusion of cash meal allowances furnished by an employer when the employee is required to be available for duty during meals; and 2) whether or not reimbursed meals or meals furnished by the employer on the employer's premises are subject to withholding under Sections 3401(a)² and 3402³ and the Federal Insurance Contribution Act.

In *Commissioner v. Kowalski*,⁴ the Supreme Court held that a cash meal allowance paid to a New Jersey state trooper was taxable income within the meaning of Section 61(a),⁵ and was not subject to exclusion by Section 119. The *Kowalski* decision overruled previous decisions allowing the exclusion under the "convenience of employer doctrine."⁶ The Court stated that Congress' enactment of Section 119 was specifically directed toward limiting exclusions for meals to those furnished by the employer, and not cash reimbursements. Additionally, Section 119 excludes only meals furnished on the business premises of the employer. Although not necessary for the *Kowalski* decision, the Court seems to have limited the "convenience of employer" wording of Section 119 to mean necessary to allow an employee "properly to perform his duties."⁷

In *Central Illinois Public Service Company v. United States*,⁸ the Supreme Court held that reimbursement of lunch expenses of employees on non-overnight company travel did not constitute wages subject to withholding by their employer within the meaning of Section 3401(a). The employees were repairmen for a utility company who were given cash reimbursements for lunch expenses if they ate at the work location. The Court stated that, even though such reimbursements may be taxable income under *Kowalski*

¹ INT. REV. CODE of 1954, § 119.

² INT. REV. CODE of 1954, § 3401(a).

³ INT. REV. CODE of 1954, § 3402.

⁴ 434 U.S. 77 (1977).

⁵ INT. REV. CODE of 1954, § 61(a).

⁶ See *United States v. Morelan*, 356 F.2d 199 (8th Cir. 1966); *Saunders v. Commissioner*, 215 F.2d 768 (3rd Cir. 1954).

⁷ 434 U.S. at 79.

⁸ 98 S. Ct. 917 (1978).

unless Congress chooses to expand the definition of wages for withholding, the judicial branch will refuse to do so.⁹ Under Section 3402, withholding is required only from wages which are defined under Section 3401(a) as "remuneration . . . for services performed by an employee for his employer." This decision overrules Revenue Ruling 70-85¹⁰ which provides that amounts paid state policemen for cost of meals (even while on duty) are taxable wages subject to withholding tax.

Although of no precedential value, in a recent private letter ruling¹¹ the Internal Revenue Service said that an employee has taxable income of the cost incurred in furnishing a meal less the amount charged when an employer operates a cafeteria at a loss for his employees.

The crucial factor in this situation seems to be that the employees were not required to eat at the cafeteria, and, therefore, according to the Service the meals were not furnished for the convenience of the employer. Such a situation could significantly impact on allocation problems in companies providing cafeteria services. To the extent that the latter half of the ruling is inconsistent with *Central Illinois Public Service Company*, the ruling does not reflect current law.

1.02 Net Gift

Is a donor who makes an inter vivos transfer of property conditioned upon the donee's payment of the gift tax subject to income tax on the amount paid as gift tax? The Tax Court and the various circuits have adopted a variety of approaches in answering the above question. The answer has differed depending upon 1) whether the gift is made to an irrevocable trust for the benefit of another and the income from the trust is used to pay the gift tax; 2) whether the gift is considered a "net gift,"¹² property less the amount of gift tax paid, to an individual who has previously agreed to pay the tax; or 3) whether the transfer is characterized as involving part sale and part gift.

The Eighth Circuit¹³ and the Fifth Circuit¹⁴ have held that where the trustee has discretion to use trust income to pay the donor's gift tax liability, such income was taxable to the donor under Section 677.¹⁵ The Fifth Circuit, however, modified this view in a later decision in which the court held

⁹ *Id.* at 919.

¹⁰ Rev. Rul. 70-85, 1970-1 CUM. BULL. 214.

¹¹ IRS LETTER RULING 7740010 (1977).

¹² See *Harrison v. Commissioner*, 17 T.C. 1350 (February 18, 1952); Rev. Rul. 71-232, 1971-1 CUM. BULL. 275.

¹³ *Estate of Sheaffer*, 37 T.C. 99 (October 31, 1961), *aff'd*, 313 F.2d 738 (8th Cir. 1963).

¹⁴ *Staley v. Commissioner*, 136 F.2d 368 (5th Cir. 1941).

¹⁵ INT. REV. CODE of 1954, § 677.

that the grantor-taxpayer realized no tangible income from payment of gift tax by the donee when he did not retain an interest in the trust.¹⁶

In *Commissioner v. Turner*,¹⁷ the Sixth Circuit adopted the view that when the donee agreed to pay the gift tax as a condition of the gift, the transfer resulted in a net gift and no benefit was given to the donor. Section 677 did not apply. Following *Turner*, the Commissioner argued in the Sixth Circuit that aside from Section 677, certain amounts paid by the donee should be taxed as income under Section 61¹⁸ and under the facts of *Johnson v. Commissioner*,¹⁹ the Sixth Circuit agreed.

The substance of the transaction in *Johnson* was a gift of \$500,000 worth of stock used as security for a \$200,000 loan which was transferred to an irrevocable trust. The trust assumed the obligation for payment of the loan, and from the proceeds of the loan, \$150,000 was used to pay the gift tax. The donor was left with \$50,000.

Section 2502(d)²⁰ states that payment of the gift tax is the donor's obligation. By extending the Supreme Court's determination that an employer's payment of an employee's income tax constitutes additional income to the employee,²¹ the Commissioner contends that payment of the gift tax by the donee results in taxable income to the donor.²² Although this view had been rejected by the Sixth Circuit in *Turner* in favor of the net gift approach, the Commissioner contends that the *Johnson* decision overruled *Turner*.²³

The Fourth Circuit has issued the most recent decision in the case of *Hirst v. Commissioner*.²⁴ In *Hirst*, an elderly widowed parent was not held liable for income taxes when she gave property to her son who agreed to pay the state and federal gift tax. Although recognizing the earlier Sixth Circuit decision in *Johnson*, the Fourth Circuit adopted the view that the previous Sixth Circuit decision of *Turner* characterizing the transaction as a net gift is controlling. *Hirst* held that since the circumstances of the transaction dispel the notion of gain to Mrs. Hirst, the amount paid as gift tax cannot be taxable as income to her.²⁵ Furthermore, the Fourth Circuit held that it is not universally true that the discharge of one's obligations is always

¹⁶ Estate of Davis, 40 P-H TAX CT. MEM. ¶ 71,318 (Dec. 30, 1971), *aff'd*, 469 F.2d (5th Cir. 1972).

¹⁷ 410 F.2d 752 (6th Cir. 1969).

¹⁸ INT. REV. CODE of 1954, § 61.

¹⁹ 495 F.2d 1079 (6th Cir. 1974).

²⁰ INT. REV. CODE of 1954, § 2502(d).

²¹ Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

²² *Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 431.

productive of income.²⁶ In the Fourth Circuit, the *Johnson* decision is limited to its particular facts. The Tax Court has also followed *Turner* in a later decision.²⁷

1.03 Scholarships

Following a National Labor Relations Board (NLRB) Ruling²⁸ that hospital interns and resident physicians are students rather than employees, the Internal Revenue Service issued Revenue Ruling 78-54²⁹ stating that the Service is not bound by the NLRB decision in cases arising under Section 117.³⁰ "The standards used for determining whether individuals are employees for purposes of labor relations are not the same as those used for federal taxation."³¹ This ruling followed the Tax Court's position as stated in *Paseiro v. Commissioner*.³²

In *Silk v. United States*,³³ the Supreme Court answered the question of whether particular workers were independent contractors or employees within the meaning of the Social Security Act by stating that the same rules are applicable as were applied by the Court to questions concerning the status of workers under the National Labor Relations Act. In light of the *Silk* decision, the question of what standards the Supreme Court would apply to determine whether interns and residents are students or employees for federal income tax purposes is unanswered.

The Service has consistently taken the position that amounts received by interns and physicians are not excludable from income as a scholarship or fellowship where services are performed to benefit the hospital.³⁴ The Tax Court has stated that where services are rendered, the amounts received are taxable as income regardless of whether the intern or resident receives valuable training.³⁵

The Third and Fourth Circuits accept the view that it is not the purpose of the facility to which the Regulations³⁶ refer, but the primary purpose of

²⁶ *Id.* at 430.

²⁷ *Victor v. Krause*, 56 T.C. 1242 (1971).

²⁸ *Cedars-Sinai Medical Center*, 223 N.L.R.B. 251 (1976).

²⁹ Rev. Rul. 78-54, 1978-1 CUM. BULL. 36.

³⁰ INT. REV. CODE of 1954, § 117.

³¹ Rev. Rul. 78-54, 1978-1 CUM. BULL. at 36.

³² 46 P-H TAX CT. MEM. ¶ 77,359 (October 6, 1977).

³³ 331 U.S. 704 (1947).

³⁴ *See, e.g.*, Rev. Rul. 72-469, 1972-2 CUM. BULL. 79; Rev. Rul. 57-386, 1957-2 CUM. BULL. 107; Rev. Rul. 70-283, 1970-1 CUM. BULL. 26.

³⁵ *See, e.g.*, *Paseiro v. Commissioner*, 46 P-H TAX CT. MEM. ¶ 78,359 (October 6, 1977); *Naman v. Commissioner*, 43 P-H TAX CT. MEM. ¶ 74,157 (June 18, 1974); *Weisfisch v. Commissioner*, 43 P-H TAX CT. MEM. ¶ 74,074 (March 27, 1974).

³⁶ Treas. Reg. § 1.117-2.

the payments that is controlling. Even though the facilities' purpose may be to train doctors, the taxpayers are paid for services rendered.

In *Leathers v. United States*,³⁷ the Eighth Circuit adopts the view that it is a question of fact whether the primary purpose is to educate and train the recipient. Under this view, if the services are found as a matter of fact to be incidental, the payment may be excluded from gross income as a scholarship.

1.04 Deferred Compensation

Proposed amendment Section 1.61-16³⁸ to Treasury Regulation Section 1.61³⁹ will require that current income be reported when an individual taxpayer has the option of determining if any portion of present compensation is to be deferred until later years when the taxpayer may be in a more favorable tax position.

Under the Service's present position, deferred compensation is not taxable until a cash basis taxpayer actually receives payment if the parties have agreed to the deferral in the original contract,⁴⁰ or before the amount is actually earned.⁴¹ By its acquiescence in *Commissioner v. Oates*,⁴² the Service may also allow the taxpayer to defer income where the amount is earned, but payment is not yet due. Additional considerations include whether the taxpayer acquires a present interest either in the amounts credited, or in an employer's annuity contract used as a funding method,⁴³ or whether the promise to pay is secured by a note or otherwise.⁴⁴

Rulings where the deferral of payment is at the sole discretion of the employer⁴⁵ will not be affected by this proposed amendment. Current revenue rulings⁴⁶ allowing an individual to elect whether or not to defer a portion of his income to a later date would appear to be no longer applicable. However, in a letter to Senator Bentsen, Treasury Tax Legislative Counsel Halperin⁴⁷ suggests limitations on the extensiveness of the proposed amendment.

Due to the difficulties involved in determining the employer's and em-

³⁷ 471 F.2d 856 (8th Cir. 1972).

³⁸ 43 Fed. Reg. 4638 (1978).

³⁹ Treas. Reg. § 1.61.

⁴⁰ Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

⁴¹ Rev. Rul. 68-86, 1968-1 CUM. BULL. 184.

⁴² 207 F.2d 711 (7th Cir. 1953).

⁴³ Rev. Rul. 72-25, 1972-1 CUM. BULL. 127.

⁴⁴ *Robinson v. Commissioner*, 44 T.C. 20 (1965).

⁴⁵ Rev. Rul. 69-647, 1969-2 CUM. BULL. 106.

⁴⁶ See, e.g., Rev. Rul. 68-86, 1968-1 CUM. BULL. 184; Rev. Rul. 68-99, 1968-1 CUM. BULL. 193; Rev. Rul. 69-650, 1969-2 CUM. BULL. 106.

⁴⁷ 11 FED. TAX COORD. 2d ¶ 29,910.

employee's reasons for allocating a portion of the payments to a deferred payment plan, in the original negotiations for salary, negotiations for renewal after the original salary negotiations, or negotiations for renewal after the original contract has expired, the regulations will not be applicable. An exception exists where there is clear evidence that the employer was "willing to pay the full deferred amount on a current basis, or that the agreement was solely for the convenience of the employee." Furthermore, in the above situation, the regulations will not be applicable even as to a "sole shareholder of a corporate employer." The effect of the proposed amendment will be limited to situations where the original contract is renegotiated before expiring, and where a contract separate from the original contract is negotiated after completion of the original agreement.⁴⁸ The Revenue Act of 1978 has frozen the situation as it relates to deferred compensation as of February 1, 1978, prior to the issuance of the proposed amendment to the Regulations.

1.05 Tuition Fees — Payments by Employer

Tuition fees paid by an employer that do not qualify as scholarships or fellowship grants, but are compensatory, are included in the employee's gross income and constitute wages for FICA, FUTA and income tax withholding purposes.⁴⁹ If the courses taken are job related, however, employer paid tuition costs are considered to be noncompensatory for the employee and a deductible business expense for the employer.⁵⁰ But if the employer reimburses the employee for job related tuition fees, the employee must account to his employer and report the reimbursement (if required) under the rules in Section 1.162-17(b) of the Regulations.⁵¹

The situation where withholding is applicable is where there is a tuition payment plan that pays the fees whether or not the courses taken will lead to a degree or are job related. If the payment does not meet the requirements of a scholarship or fellowship grant,⁵² or directly meets the educational maintenance and improvement requirements,⁵³ then the payment serves as compensation for past or present services, or as an inducement for future services.⁵⁴ However, the educational expenses may qualify as itemized deductions for the individual employee under Section 1.162-5(c)⁵⁵ of the Regulations as maintaining or improving existing skills.⁵⁶

⁴⁸ *Id.* at 29,910.

⁴⁹ Rev. Rul. 78-184, 1978-1 CUM. BULL. 304.

⁵⁰ Rev. Rul. 76-71, 1976-1 CUM. BULL. 308.

⁵¹ Treas. Reg. § 1.162-17(b).

⁵² See INT. REV. CODE of 1954, § 117.

⁵³ See Treas. Reg. § 1.162-5(c).

⁵⁴ Rev. Rul. 76-352, 1976-2 CUM. BULL. 37.

⁵⁵ Treas. Reg. § 1.162-5(c).

⁵⁶ Rev. Rul. 76-352, 1976-2 CUM. BULL. 37.

1.06 Severance Payments

In *Arnold Chekow*,⁵⁷ the taxpayer, an attorney, was employed by a professional service corporation. The taxpayer owned stock in the corporation, but was never required to make a capital investment. A severance payment was made upon taxpayer's departure from the law firm. The firm deducted \$9,000 as additional compensation in the nature of severance pay, while the taxpayer reported the amount as a long term capital gain from the surrender of his stock in the firm.

The Commissioner argued that the payments were ordinary income and not capital gains and that, therefore, the law firm could deduct the payments but that the taxpayer was required to report the payment as ordinary income. The Tax Court agreed with the Commissioner, maintaining that since there had been no capital contribution for the stock, there could be no capital gain for the surrender of the stock. Furthermore, the court noted that the payment was not in relation to the taxpayer's claimed ownership in the firm.⁵⁸ The court concluded that the taxpayer was never a real shareholder for tax purposes.⁵⁹

1.07 Deferral of Farm Income

The Tax Court in *Schniers v. Commissioner*⁶⁰ held that a taxpayer did not constructively receive income from the sale of cotton in the year the cotton was grown but realized income in the year when actually paid. On March 13, 1973, the taxpayer entered into two contracts to sell all of the cotton harvested from two specific plots of land to a cotton company at a price keyed to government loan values.⁶¹ Pursuant to the contracts, the taxpayer planted, harvested and ginned the cotton during the months of November and December in 1973.⁶²

On or about December 4, 1973, the taxpayer entered into five deferred payment contracts which provided that no advance or payment of any kind would be made by the cotton company prior to January 2, 1974, regardless of the delivery date. The taxpayer was paid pursuant to the terms of the contract.⁶³

The taxpayer desired to spread his income over a two-year period. This

⁵⁷ 1978 P-H TAX CT. MEM. ¶ 78,330 (August 21, 1978).

⁵⁸ *Id.* at 78-355. The taxpayer claimed ownership of 25% in the firm for a net worth of approximately \$73,000, yet his payment for the redemption of his stock was only \$9,000.

⁵⁹ *Id.*

⁶⁰ 69 T.C. 511 (1977).

⁶¹ *Id.* at 512.

⁶² *Id.*

⁶³ *Id.* at 513.

was necessary because a cotton crop planted during 1972 was harvested and sold in early 1973.⁶⁴

The IRS maintained that under Section 1.451-(2)(a)⁶⁵ of the Regulations the taxpayer had constructively received the proceeds from the deferred payment contracts upon the signing of the contract on December 4, 1973.⁶⁶ The Tax Court noted that the contract of March 13, 1973, provided no specific date for payment.⁶⁷ However, the deferred payment contracts expressly provided for payments on or after January 2, 1974.⁶⁸ The court concluded that a valid binding contract with the objective to conduct business transactions so as to reduce the incidence of federal taxation does not make it any less a bona fide contract.⁶⁹ The court held that the transaction was not a sham because the evidence showed that the parties looked upon the contract as an instrument defining their legal rights.⁷⁰

An alternative argument advanced by the IRS in the Tax Court was that the taxpayer had changed his accounting method without prior approval of the Secretary as mandated under Section 446(e)⁷¹ of the Code and Section 1.446-1(e)(2)⁷² of the Regulations.⁷³ The court ruled that the execution of these contracts was not a change in the taxpayer's method of accounting, noting that farmers have great flexibility in timing the receipt of taxable income.⁷⁴

Another cotton farmer did not fare so well in the Tax Court. In *H. N. Watson, Jr. v. Commissioner*,⁷⁵ the taxpayer entered into a deferred payment agreement on November 29, 1973, for the sale of cotton. The taxpayer was to receive as consideration for the sale an irrevocable banker's letter of credit which the bank guaranteed it would accept and honor on January 10, 1974.⁷⁶ The Tax Court held that the letter of credit received by the taxpayer was property within the meaning of Section 1001(b).⁷⁷ Under Texas statute,⁷⁸

⁶⁴ *Id.*

⁶⁵ Treas. Reg. § 1.451-(2)(a).

⁶⁶ 69 T.C. at 515.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 516.

⁷⁰ *Id.*

⁷¹ INT. REV. CODE of 1954, § 446(e).

⁷² Treas. Reg. § 1.446-1(e)(2).

⁷³ 69 T.C. at 519-20.

⁷⁴ *Id.* at 520.

⁷⁵ 69 T.C. 544 (1978).

⁷⁶ *Id.* at 547-48.

⁷⁷ *Id.* at 549.

⁷⁸ TEX. BUS. & COM. CODE ANN. tit. 2, § 5.106(a)(2) (Vernon 1968).

the taxpayer, as the beneficiary of the letter of credit, is the only party allowed to modify or revoke the credit. Thus, the Tax Court accepted the Service's argument that an irrevocable banker's letter of credit is equivalent to cash.⁷⁹

In conclusion, farmers attempting to defer income must carefully construct the transaction so as to avoid the lumping of income into one calendar year. In addition, the effects of state law must be considered to avoid transforming a deferred payment into the equivalent of cash.

2.00 Exclusions From Income

3.00 Exemptions

3.01 Dependency Exemption — Children of Divorced Parents

In Revenue Ruling 78-91⁸⁰ the IRS sought to clarify Revenue Ruling 73-175⁸¹ and Section 152(e) (2)⁸² concerning the dependency exemption for children of divorced parents. The situation covered by Revenue Ruling 78-91 is where "A and B are divorced parents of three children. . . . The decree of divorce provided that A would be allowed to claim exemptions of the three children as long as A made support payments of \$100 a month for each child. During 1977 A made 12 payments of \$300 each."⁸³ B married C during 1977. B had no income, but contributed to the care of the three children from C's income. The problem lies in the fact that B and C together contributed more than A and B for the support of the children.

Revenue Ruling 78-91 makes it clear that C's contributions for support may be attributed to B, so that A and B together with contributed payments from C will meet the one-half support requirement of Section 152(e) (1).⁸⁴ After the divorced parents meet the combined support rule, the parents may then proceed to the special rule of Section 152(e) (2). Since A and B had a dependency allowance clause in their divorce decree, and A met the \$600 support requirement,⁸⁵ then A is entitled to the dependency exemptions for the three children.

The reasoning behind Revenue Rulings 78-91 and 73-175 was first announced in *Colton v. Commissioner*,⁸⁶ which held that it was immaterial

⁷⁹ 69 T.C. at 552.

⁸⁰ Rev. Rul. 78-91, 1978-1 CUM. BULL. 36.

⁸¹ Rev. Rul. 73-175, 1973-1 CUM. BULL. 58.

⁸² INT. REV. CODE of 1954, § 152(e)(2).

⁸³ Rev. Rul. 78-91, 1978-1 CUM. BULL. at 36-37.

⁸⁴ INT. REV. CODE of 1954, § 152(e)(1).

⁸⁵ INT. REV. CODE of 1954, § 152(e)(2)(A)(ii).

⁸⁶ 56 T.C. 471 (1971).

whether the support payments were from the former husband's funds alone, from jointly owned funds, or from his new wife's funds.⁸⁷

"The objective of the Section 152 (e) exceptions was to allow the divorced parents to agree between themselves that the noncustodial parent would have the dependency deductions. . . . Congress did not intend this objective to be defeated by remarriage of divorced parents."⁸⁸ Otherwise, as under the previous rule,⁸⁹ the payments of the custodial parent and new spouse would have to be traced, and the problems of community and non-community property rules, which *Colton* sought to avoid, would arise.

4.00 Deductions

4.01 Medical Expense — Capital Improvements

In *Ferris v. Commissioner*,⁹⁰ the Seventh Circuit recently held that the allowable medical deduction for a swimming pool addition to the taxpayer's home is "[t]he minimum reasonable cost of a functionally adequate pool and housing structure . . ."⁹¹ reduced by the increase in property value due to the building structure. This decision reversed the Tax Court⁹² and the case was remanded for a factual determination of the minimum reasonable cost and the increase in the value of the property.

The swimming pool was constructed after a physician advised the taxpayer, who suffered from a spinal injury, to swim twice daily to prevent paralysis. The swimming pool was constructed at a cost of \$194,660. The materials and workmanship of the structure were comparable to the taxpayer's residence which was valued at \$275,000 before the addition. An appraisal indicated that the swimming pool addition increased the value of the taxpayer's residence by \$86,160. Subtracting this amount and the costs of non-essential items amounting to \$22,500, from the total costs of the pool addition resulted in an \$86,000 medical expense deduction according to the taxpayer. Despite the Service's contention that a large part of the cost additions was due to the personal taste of the taxpayer, the Tax Court allowed the deductions maintaining that taxpayers are not limited to the cheapest form of medical treatment available.⁹³

The Seventh Circuit pointed out that even though individuals may choose

⁸⁷ *Id.* at 474-75.

⁸⁸ Rev. Rul. 78-91, 1975-1 CUM. BULL. at 37.

⁸⁹ Rev. Rul. 71-19, 1971-1 CUM. BULL. 43.

⁹⁰ 42 Am. Fed. Tax R.2d 78-5674 (7th Cir. August 15, 1978).

⁹¹ *Id.* at 5677.

⁹² 345 P-H TAX CT. MEM. ¶ 77,186 (June 14, 1977). See also Briner, *Federal Income Tax Developments: 1977*, 11 AKRON L. REV. 227, 235 (1977).

⁹³ 45 P-H TAX CT. MEM. ¶ 77,186 at 766 (June 14, 1977).

an expensive physician or select a private room over a cheaper form of treatment, such care is direct and distinguishable from the present situation which is indirect. Any costs above those necessary to produce a functionally adequate facility are not incurred for medical care.⁹⁴

Although the Service had offered some evidence that an enclosed pool satisfying the taxpayer's medical needs could have been built for \$70,000 and that such a structure would increase the property's value by \$31,000, the Seventh Circuit held that this evidence was insufficient to make a decision as to how much medical deduction to allow. Furthermore, there was some evidence presented that the addition of a \$70,000 structure would actually reduce the value of the taxpayer's residence, in which case, the entire \$70,000 would be allowed as a deduction.

4.02 Medical Expense — Disability Insurance Premiums

In *Curtis A. Weber*,⁹⁵ the Tax Court upheld a determination by the Commissioner that the premiums paid for an insurance policy that only provided for indemnity in the case of total disability were not deductible as medical expenses under Section 213.⁹⁶

The petitioner had an insurance contract with the Allstate Insurance Company whereby Allstate agreed to pay a monthly benefit of \$500 for each month of the insured's total disability resulting from sickness, subject to certain limitations. The policy defined total disability as disability that continuously prevents the insured from performing the duties of his occupation. The petitioner contended that the premiums paid for this coverage were deductible under Section 213.

Section 213 (a)⁹⁷ allows a taxpayer to deduct amounts paid for the medical care of the taxpayer, his spouse and dependents. Medical care is defined in the Code as including amounts paid for insurance covering the cost of diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body.⁹⁸

The Tax Court noted that "[t]he report of the Committee on Ways and Means explaining the statutory language [of Section 213] stated that insurance contracts providing indemnity for loss of income, or for loss of life, limb or sight, are insurance for other than medical care."⁹⁹ The court concluded, therefore, that:

⁹⁴ 42 Am. Fed. Tax R.2d at 5677.

⁹⁵ 1978 P-H TAX CT. MEM. ¶ 78,110 (February 21, 1978).

⁹⁶ INT. REV. CODE of 1954, § 213.

⁹⁷ *Id.* at § 213(a).

⁹⁸ *Id.* at §§ 213(e)(1)(A), (C).

⁹⁹ 1978 P-H TAX CT. MEM. ¶ 78,110 at 492.

Based on a review of the provisions of the policy, it is clear that no part of the \$229.00 premium is deductible by the petitioner under the provisions of section 213. The policy provided for indemnity for loss of income or loss of life, limb and sight, not for the cost of services described in section 213. The triggering event of [the coverage] was disability. Petitioner could have collected from Allstate without incurring any cost of medical care. Furthermore, the fact that the policy had a provision relating the benefits to the insured's earnings further evidences the fact that [the coverage] indemnified petitioner for loss of earnings rather than the cost of medical care.¹⁰⁰

4.03 Medical Expense — Laetrile

Section 213¹⁰¹ permits a deduction of payments for certain medical expenses, including expenses for medicine and drugs, actually paid by the taxpayer during the taxable year. The term medicine and drugs includes "only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs."¹⁰²

Revenue Ruling 78-325¹⁰³ established that amounts paid by a taxpayer for laetrile are amounts paid for medicine and drugs and are deductible as medical expenses under Section 213 where the use of laetrile was prescribed by the taxpayer's physician and the drug was used in a locality where the sale and use of laetrile is legal.

4.04 Research and Development Expenses

In *Carl R. Johnson*,¹⁰⁴ the taxpayer was in the business of selling tax shelter annuities. In addition he claimed to have been engaged in the study of economics, with particular relation to the gross national product. The taxpayer deducted, pursuant to Section 174,¹⁰⁵ all of his normal living expenses such as food, shelter and transportation. The IRS maintained that the taxpayer's normal living expenses could not be deducted as research and development expenses. The taxpayer argued that his research related to money, so that everything he spent was part of his research.¹⁰⁶

The Tax Court rejected the taxpayer's contentions and held that there were no deductible research development expenses.¹⁰⁷ The court noted that research and development expenses are deductible only if they are made

¹⁰⁰ *Id.*

¹⁰¹ INT. REV. CODE of 1954, § 213.

¹⁰² 26 C.F.R. § 213-1(e)(2).

¹⁰³ Rev. Rul. 78-325, 1978-36 INT. REV. BULL. 24.

¹⁰⁴ 37 CCH TAX CT. MEM. ¶ 35,307 (1978).

¹⁰⁵ INT. REV. CODE of 1954, § 174.

¹⁰⁶ 37 CCH TAX CT. MEM. ¶ 35,307 at 1232.

¹⁰⁷ *Id.*

by the taxpayer "in connection with his trade or business."¹⁰⁸ The expenses deducted by the taxpayer were "not for the purpose of research and development, but to meet the personal needs of the taxpayer."¹⁰⁹

4.05 Medical and Charitable Deductions — Credit Cards

Revenue Rulings 78-38¹¹⁰ and 78-39¹¹¹ dealing with charitable and medical deductions were in response to the Tax Court's decision in *Grannan v. Commissioner*.¹¹² In *Grannan*, the taxpayer executed a note to a hospital for his dependent sister's medical costs. The hospital transferred the note to a bank for the full amount and later the taxpayer borrowed money to pay off the note. The taxpayer then took medical deductions as he made payments on the loan, most of the payments being made the following year. The court held that the medical costs were deductible in the year the note was executed and that the deduction was not postponed to the years the loan is repaid.¹¹³ Under these revenue rulings, credit card charges for medical expenses and charitable contributions are deductible in the year the charge is made regardless of when the bank is repaid. Since the card holder cannot prevent receipt of his contribution or payment, the transaction is deemed the equivalent of borrowing funds to make the deductible payment or contribution.

4.06 Illegal Rebates and Discounts

The Tax Court has arrived at a compromise between an earlier line of cases and Section 162 (c)¹¹⁴ on illegal payments. In *James Alex*,¹¹⁵ the taxpayer, a life insurance salesman, made rebates and discounts to new purchasers contrary to state law. Under his contract with the insurance company the taxpayer could receive commissions greater than the policies' first year premiums. A discount and rebate scheme was devised whereby purchasers would pay little or nothing of the first year premiums. From the amount received for commissions, the taxpayer would deduct "discounted premiums."

The issue was whether the "discounted premiums" were an adjustment to gross income or a business expense deduction. The Tax Court placed great emphasis on the word *deduction* in Section 162 (c) (2),¹¹⁶ holding that

¹⁰⁸ INT. REV. CODE of 1954, § 174(a)(1). See *Briner*, *supra* note 92, at 243.

¹⁰⁹ 37 CCH TAX CT. MEM. ¶ 35,307 at 1232.

¹¹⁰ Rev. Rul. 78-38, 1978-1 CUM. BULL. 67.

¹¹¹ Rev. Rul. 78-39, 1978-1 CUM. BULL. 73.

¹¹² 55 T.C. 753 (1971).

¹¹³ *Id.* at 755.

¹¹⁴ INT. REV. CODE of 1954, § 162(c).

¹¹⁵ 70 P-H T.C. ¶ 70.29 (May 24, 1978).

¹¹⁶ INT. REV. CODE of 1954, § 162(c)(2).

illegal discount and rebate *deductions* would be disallowed.¹¹⁷ However, the illegal rebates and discounts would be allowed as adjustments to gross income for actual purchase prices as in *Pittsburgh Milk v. Commissioner*.¹¹⁸

The court noted, however, in *James Alex*, that only the buyer or seller may adjust gross income in this manner.¹¹⁹ In this case the insurance company was the seller and not the taxpayer. The premiums were established by the insurance company, the contracts were actually sold by the company, the company assumed all contract liability, and the company was entitled to the premiums. Thus, as far as the taxpayer was concerned, the illegal discounts and rebates were deductions and not allowable under Section 162(c).

4.07 Hedge Agreements — Unreasonable Salary

The hedge agreement requires that an officer-shareholder repay to the corporation those amounts which are later disallowed as unreasonable compensation. Such an agreement avoids the problems of double taxation that result when the payments are treated as dividends to the shareholder in addition to being nondeductible to the corporation.

The hedge agreement, however, may be becoming a two-edge sword. In *Castle Ford, Inc.*,¹²⁰ the Tax Court stated that the hedge agreement between the sole shareholder-president and Castle Ford, "contemplated the possibility that a portion of the salary might be disallowed as unreasonable — an element which is entitled to some consideration."¹²¹

The Tax Court's reasoning was first adopted by the Eighth Circuit Court of Appeals in *Charles Schneider & Co., Inc. v. Commissioner*,¹²² where the court found that the hedge agreement, "may reflect a pre-existing knowledge on the part of the taxpayers that the payments would not be reasonable for tax purposes, and could lead to an inference as to their intent."¹²³ This same analysis has also been applied in the Fifth Circuit to infer pre-existing knowledge of the salary's unreasonableness.¹²⁴

Despite these decisions the hedge agreement remains a viable tax planning device since it is only one of the elements that will be considered in determining the reasonableness of the compensation. In all of these cases the record of low dividends, sudden jumps in salary, and the sole authority of the

¹¹⁷ 70 P-H T.C. at 180.

¹¹⁸ 26 T.C. 707 (1956).

¹¹⁹ 70 P-H T.C. at 180.

¹²⁰ 1978 P-H TAX CT. MEM. ¶ 78,157 (April 28, 1978).

¹²¹ *Id.* at 688.

¹²² 500 F.2d 148 (8th Cir. 1974).

¹²³ *Id.* at 155.

¹²⁴ *Saia Electric Co. v. Commissioner*, 536 F.2d 388 (5th Cir. 1976).

shareholder-officer to set his salary remained the most important elements considered by the courts.

4.08 Deduction for Estate Taxes — I.R.D.

“Income in respect of a decedent” is defined as “those amounts to which a decedent was entitled as gross income but which were not properly included in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.”¹²⁵ Under Section 691 (a)¹²⁶ the amount of all items of gross income in respect of a decedent that are not included in computing the decedent’s taxable income shall be included in the gross income for the taxable year received, of the person, who by reason of the death of the decedent, acquires the right to receive the amount. Section 691 (c)¹²⁷ provides that a taxpayer who is required to include in gross income an amount in respect of a decedent may deduct that portion of the estate tax imposed upon the decedent’s estate which is attributable to the inclusion in the decedent’s estate of the right to receive such amount.

Revenue Ruling 78-203¹²⁸ addressed the issue of whether the amount deductible under Section 691 (c) was to be claimed as an itemized deduction or as a deduction from gross income in arriving at adjusted gross income. The Service concluded that “for purposes of computing the regular income tax under part I of Subchapter A of the Code, [the taxpayer] must take the deduction allowed by section 691 (c) of the Code as an itemized deduction subject to any limitations and restrictions on deductions generally and not as a deduction from gross income in arriving at adjusted gross income.”¹²⁹

4.09 Interest — Loans on Insurance Policy

The Court of Claims held in *Lee v. United States*¹³⁰ that the interest paid to a life insurance company in connection with a loan transaction that required prepayment of premiums and the subsequent borrowing of the same amount from the life insurer at interest is not deductible.¹³¹ The disallowed transaction consisted of the taxpayer paying the annual premium, the present value of the next four years’ premiums discounted at three percent, and the interest on the amount borrowed contemporaneously at four percent. When the prepaid premium fund was supplemented by the three percent interest earned on the amount, it was sufficient to pay the next four years’ premiums.

¹²⁵ 26 C.F.R. § 691(a)-1(b).

¹²⁶ INT. REV. CODE of 1954, § 691(a).

¹²⁷ INT. REV. CODE of 1954, § 691(c).

¹²⁸ Rev. Rul. 78-203, 1978-1 CUM. BULL. 199.

¹²⁹ *Id.* at 199.

¹³⁰ 571 F.2d 1180 (Ct. Cl. 1978).

¹³¹ *Id.* at 1184.

The loans and interest equaled the cash surrender value of the policies, and the cash surrender value was always greater than the amounts added to replenish the prepaid fund. The taxpayer borrowed against the increased cash surrender value to its full amount. These transactions were found by the court to be like those in *Ballagh v. United States*¹³² where the prepayment of premiums and the borrowing back of the same amount at interest was held to be a sham transaction.¹³³

The interest deductions were allowed, however, when the taxpayer did not use a prepaid fund. In that situation the taxpayer still borrowed against the full cash surrender value to pay mainly the subsequent years' premiums. The court based its reasoning on the illiquidity of the taxpayer and found the latter transactions to be equivalent to borrowing from a bank to pay annual premiums.¹³⁴

4.10 Education Expense

The IRS has tried unsuccessfully to deny deductions of educational expenses to those who have left their jobs with no specific intent to return or to those who are unemployed after furthering their education. In *Robert J. Picknally*,¹³⁵ the taxpayer had resigned from his job as a school principal to obtain a Ph.D. in educational administration. After obtaining the degree the taxpayer was unemployed, but he had held part-time jobs relating to his trade or business. The IRS disallowed his educational expense deductions on the grounds that the taxpayer was not engaged in a trade or business within the meaning of Section 1.162-5 (a) (1) of the Regulations.¹³⁶ The Tax Court, citing prior cases,¹³⁷ stated that a taxpayer can still be engaged in a trade or business, although currently unemployed, if he was previously involved in and intends to return to that trade or business. However, amounts expended in preparation for the resumption of a business or trade at some indefinite time are not deductible.¹³⁸ Since the taxpayer was actively seeking a job in the same trade or business and had not been employed in another profession during this time, the deduction was allowed. The court rejected the argument of indefiniteness based solely upon the fact that the taxpayer had been unemployed for a period of more than one year.

In a later case, *Donald C. Hitt*,¹³⁹ the taxpayer's spouse left her em-

¹³² 331 F.2d 874 (Ct. Cl. 1964).

¹³³ *Id.* at 878.

¹³⁴ 571 F.2d at 1185.

¹³⁵ 46 P-H TAX CT. MEM. ¶ 77,321 (September 20, 1977).

¹³⁶ Treas. Reg. § 1.162-5(a)(1).

¹³⁷ *See, e.g.,* Haft v. Commissioner, 40 T.C. 2 (April 3, 1963).

¹³⁸ *See, e.g.,* Owen v. Commissioner, 23 T.C. 377 (November 30, 1954).

¹³⁹ 1978 P-H TAX CT. MEM. ¶ 78,066 (March 3, 1978).

ployment for a doctoral program with no specific intention to return to her former job. However, after she had completed the education she returned to the same job. The deductions were disallowed by the IRS on the premise that she was not carrying on a trade or business while obtaining her degree. The Tax Court reversed, holding that she had only temporarily removed herself to sharpen the skills required for her same trade or business. The three years taken were appropriate for this objective and the doctorate would not equip her for a different career. The deduction was allowed, but the court added the caveat that the longer one is away from his former job, the greater the weight of evidence that the taxpayer is no longer carrying on a trade or business while attending school.¹⁴⁰ The taxpayer was also permitted to deduct the costs of meals and lodging incurred by his spouse while away from home and attending college since she was only temporarily away from home and still in her trade or business.¹⁴¹

4.11 Business Expense — Rental Expense

Under the provisions of Section 162¹⁴² a business may deduct the ordinary and necessary expenses of conducting its business.¹⁴³ However, rental expenses are allowed as a deduction under Section 162 only if they are reasonable.¹⁴⁴

In *O.T.M. Corp.*,¹⁴⁵ two businesses were controlled by common ownership. During the audit of one of the businesses, O.T.M. Corp., the IRS determined that the other business had been charging O.T.M. Corp. unreasonable rental costs for equipment. As a result, the Service denied as a deduction the amounts deemed unreasonable. However, the Service also denied the other business' claim that its income should have been reduced by the amount deemed excessive. This determination resulted in an additional \$17,474 of income tax liability.¹⁴⁶

The taxpayer brought suit claiming that the IRS must allocate income and deductions among controlled corporations pursuant to Section 482.¹⁴⁷ However, the Fifth Circuit Court of Appeals affirmed the district's court rejection of this argument.¹⁴⁸ The court agreed that if the IRS had relied on Section 482, then the income of the other corporation would have been

¹⁴⁰ See, e.g., *Canter v. United States*, 354 F.2d 352 (Ct. Cl. 1965).

¹⁴¹ 1978 P-H TAX CT. MEM. ¶ 78,066 at 335.

¹⁴² INT. REV. CODE of 1954, § 162.

¹⁴³ See *Tulia Feedlot, Inc. v. United States*, 513 F.2d 800 (5th Cir. 1975).

¹⁴⁴ See *Brown Printing Co. v. Commissioner*, 255 F.2d 436 (5th Cir. 1958).

¹⁴⁵ 77-2 U.S.T.C. ¶ 9693 (1977), *aff'd*, 78-2 U.S.T.C. ¶ 9430 (5th Cir. 1978).

¹⁴⁶ *Id.* at 88,338.

¹⁴⁷ INT. REV. CODE of 1954, § 482.

¹⁴⁸ 78-2 U.S.T.C. ¶ 9430 at 9431.

proportionally reduced. But the court concluded that since the IRS denied the deduction as unreasonable under Section 162, the provisions of Section 482 are inapplicable.

4.12 Sale and Leaseback Arrangement

In *Frank Lyon Co. v. United States*,¹⁴⁹ the United States Supreme Court reversed the Eighth Circuit Court of Appeals¹⁵⁰ and upheld a sale and leaseback arrangement thereby permitting the taxpayer to deduct depreciation on the building and other expenses relating to the transaction.¹⁵¹ Justice Blackmun, writing for a seven to two majority, noted that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes."¹⁵²

In *Lyon*, the Worthen Bank & Trust Company desired to construct a multistory bank and office building. However, due to banking regulations, Worthen was unable to finance the construction with its own funds.¹⁵³ In order to effectuate construction of the building, Worthen proposed a sale and leaseback arrangement.¹⁵⁴ The plan was approved subject to certain conditions¹⁵⁵ by both the Arkansas State Bank Department and the Federal Reserve Board.¹⁵⁶

Following negotiations, the terms of the sale and leaseback arrangement were set forth in four documents executed in May, 1968. The first document was a ground lease from Worthen to Lyon of the land upon which the building was to be constructed. The lease term was seventy-six years and seven months (May 1, 1968 through November 30, 2044). The ground rent was \$50 for the first twenty-six years and seven months; \$100,000 a year for the next five years; \$150,000 a year for the next five years; \$200,000 a year for the next five years; \$250,000 a year for the next twenty-five years; and \$10,000 a year for the final ten years.

The second document was a sales agreement dated May 19, 1968, between Worthen and Lyon. Under the terms of this agreement Worthen, which was actually constructing the building, agreed to sell it to Lyon, piece by piece, as constructed, for a total price not to exceed \$7,640,000.

¹⁴⁹ 435 U.S. 561 (1978).

¹⁵⁰ 536 F.2d 746 (8th Cir. 1976).

¹⁵¹ 435 U.S. at 584.

¹⁵² *Id.*

¹⁵³ *Id.* at 563-64.

¹⁵⁴ *Id.* at 564.

¹⁵⁵ The Arkansas State Bank Department required that Worthen possess an option to purchase the leased property at the end of the fifteenth year of the lease at a set price. The Federal Reserve Board required that the building be owned by an independent third party.

¹⁵⁶ 435 U.S. at 564.

Under the terms of the third document, Lyon was to lease the building back to Worthen for a primary term of twenty-five years beginning on December 1, 1969, with options to extend the lease for eight additional five-year periods. The building lease was a net lease, making Worthen responsible for all repairs, insurance, taxes and utility charges. For the first eleven years of the lease, the rent was \$582,324 a year. For the next fourteen years the rent was \$613,157 per year. Under the renewal options the rent was \$300,000 a year. Worthen was given an option to repurchase the building and leasehold on November 30, 1980, at a price of \$6,325,170; on November 30, 1984, at a price of \$5,432,607; on November 30, 1989, at a price of \$4,187,328 and on November 30, 1994, at a price of \$2,145,935.

The fourth document was a permanent financing agreement between the New York Life Insurance Company and Lyon for \$7,140,000 in the form of a 6¾% twenty-five year self amortizing loan, with full recourse against Lyon's net worth.¹⁵⁷

The Internal Revenue Service determined that Lyon was not the owner of the building for tax purposes and therefore, could not deduct interest on the debt or depreciation on the building. The Service assessed a deficiency in Lyon's federal income tax for 1969 in the amount of \$280,387.20 including interest.¹⁵⁸ Lyon paid the assessment and filed a timely claim for its refund.¹⁵⁹ The district court ruled in Lyon's favor and held that the claimed deductions were allowable.¹⁶⁰ The Eighth Circuit Court of Appeals reversed.¹⁶¹ The Supreme Court granted certiorari in the case because of a conflict with the Fourth Circuit Court of Appeals decision in *American Realty Trust Co. v. United States*.¹⁶²

The Court rejected the government's contention that the decision in *Helvering v. Lazarus & Co.*¹⁶³ was controlling. The Court noted that the present case involved three parties, Worthen, Lyon and New York Life¹⁶⁴ and "[t]hus, the presence of the third party . . . significantly distinguishes this case from *Lazarus* and removed the latter as controlling authority."¹⁶⁵

The factor that was deemed the most significant by the Court was the fact that Lyon alone, and not Worthen, was primarily liable on the notes to

¹⁵⁷ *Id.* at 565-68.

¹⁵⁸ *Id.* at 569.

¹⁵⁹ *Id.*

¹⁶⁰ 36 Am. Fed. Tax R.2d 75-5059 (1975).

¹⁶¹ 536 F.2d 746 (8th Cir. 1976).

¹⁶² 498 F.2d 1194 (4th Cir. 1974).

¹⁶³ 308 U.S. 252 (1939).

¹⁶⁴ 435 U.S. at 575.

¹⁶⁵ *Id.* at 576.

New York Life. "No matter how the transaction could have been devised otherwise, it remains a fact that as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon. Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk."¹⁶⁶ The Court concluded,

that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.¹⁶⁷

5.00 Tax Credits

6.00 Depreciation

7.00 Gains and Losses

7.01 Capital Gains — Installment Sales

In *William D. Pityo*,¹⁶⁸ the taxpayer acquired 20% control of Arvin Industries, Inc. (hereinafter Arvin) in 1967 through the purchase of a block of Arvin's common stock. After the taxpayer had terminated his employment as vice president of the company in 1971, he began investing in oil wells. The taxpayer incurred a \$175,000 loss from the oil business in 1971 and 1972. In addition, the taxpayer incurred liability for a \$200,000 loan procured for the business.¹⁶⁹

Because of the taxpayer's financial plight and the fact that the block of Arvin stock made up 90% of the taxpayer's assets, the taxpayer began investigating other possible investments. He agreed with his financial adviser and private attorney to sell his appreciated property (securities) to three separate trusts set up for the benefit of his wife and two minor children in return for receiving long term installment notes as consideration for the selling price.¹⁷⁰ Within a short period of time, the trustee, a local bank, sold 21,500 shares of Arvin and invested the cash proceeds in a mutual funds periodic withdrawal program.¹⁷¹ From the regular withdrawals from the mutual funds, the trustee made the required payments under the installment notes of \$4,300 per month for 240 months to the taxpayer.¹⁷² Under the installment contract,

¹⁶⁶ *Id.* at 577.

¹⁶⁷ *Id.*

¹⁶⁸ 70 P-H T.C. ¶ 70.21 (May 15, 1978).

¹⁶⁹ *Id.* at 126.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 127.

¹⁷² *Id.* at 128.

the payments for the first year were less than thirty percent of the selling price.

In this particular fact pattern, the taxpayer had attempted to convert his assets into ready cash and defer the gain over a period of time by the installment method. Section 453¹⁷³ provides that the Secretary shall prescribe regulations allowing a taxpayer to dispose of personal property on an installment plan to consider as income that proportion of the installment actually received in the tax year to which the gross profit is realized or to be realized as it relates to the contract price. Simply put, the taxpayer must report each year only the profit generated by the installment payments. A sale or other disposition under Section 453 has been construed by Revenue Ruling 65-155¹⁷⁴ to also mean an exchange hereby allowing the taxable gain to be proportioned over the installment period. Selling price is defined as the total consideration received by the vendor including liabilities assumed by the purchaser which in turn include the amount of any mortgage on the property sold.¹⁷⁵ The selling price is determined only by the face amount of the installment contract; it is never determined by the use of market valuation techniques.¹⁷⁶

The individual taxpayer, in order to meet the prerequisites of Section 453, must insure that the payments in the year of the sale, disregarding evidences of indebtedness of the purchaser and liabilities assumed by the purchaser, do not exceed 30% of the selling price.¹⁷⁷ The vendor need not receive any payment in the year of the sale.¹⁷⁸

An element essential to the transaction is economic substance. In Revenue Ruling 74-157,¹⁷⁹ the Internal Revenue Service denied Section 453 tax treatment to the taxpayer upon the sale of stock at fair market value by a father to his son who later resold to an unrelated party. The main reason for the unfavorable treatment was that the first sale under the preconceived negotiated, plan lacked economic substance.¹⁸⁰ Economic substance is lacking when there is no legitimate purpose for the transaction as when the transaction serves only as an artful and crafty design to cheat the government out of revenues. Revenue Ruling 73-536¹⁸¹ held that a purported installment sale between family members followed shortly thereafter by a resale to an

¹⁷³ INT. REV. CODE of 1954, § 453(a).

¹⁷⁴ Rev. Rul. 65-155, 1965-1 CUM. BULL. 326.

¹⁷⁵ Treas. Reg. § 1.453-4(e).

¹⁷⁶ Treas. Reg. § 1.453-1(b)(1); Rev. Rul. 74-384, 1974-2 CUM. BULL. 152.

¹⁷⁷ INT. REV. CODE of 1954, § 453(b)(2)(ii).

¹⁷⁸ *Id.* at § 453(b)(2)(a)(ii); Treas. Reg. §§ 1.453-1(c)(1)-4(b)(1).

¹⁷⁹ Rev. Rul. 73-157, 1973-1 CUM. BULL. 313.

¹⁸⁰ *Id.*

¹⁸¹ Rev. Rul. 73-536, 1973-2 CUM. BULL. 158.

unrelated third party lacked substance where it was the intention of the family members to resell the property and receive full payment upon such resale.

In the present case, the court recognized that the installment sale to the trusts was a key device in obtaining financial security for the taxpayer's family.¹⁸² Both parties had stipulated that the gain from the sale of the Arvin stock should be accorded capital gain treatment.¹⁸³ The essential issue was whether the capital gain should be reported in the year the stock was sold by the trustee or as the taxpayer received the installment payments.¹⁸⁴ The Service's position was that the trustee was a mere conduit of title for the taxpayer's sale of the stock on the open market.¹⁸⁵ The Tax Court announced that it would follow the principle espoused in *Griffiths v. Commissioner*¹⁸⁶ and examine the actual command over the property and not the form of the transaction.

The test applied by the court was enunciated by the Fifth Circuit Court of Appeals in *Commissioner v. Rushing*.¹⁸⁷ In order for the taxpayer to qualify the transaction under the installment sale provisions, the taxpayer "may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom."¹⁸⁸

The Tax Court believed that the taxpayer had fulfilled the requirements set forth in *Rushing*. The Court noted that the taxpayer had been advised by his private counsel of the consequences of his action in establishing the irrevocable trusts.¹⁸⁹ The provisions of the trust expressly empowered the trustee to utilize his own sound judgment in investing the corpus of the trust.¹⁹⁰ In addition, the express provisions in the trust allowing the trustee to invest in mutual funds were included to comply with the Federal Reserve Bank policy.¹⁹¹

An important element in the court's determination that the taxpayer never had direct or indirect control over the proceeds from the sale of stock was the fact that the taxpayer had no contact with the trustee after the

¹⁸² 70 P-H T.C. at 130.

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 129.

¹⁸⁵ *Id.*

¹⁸⁶ 308 U.S. 355, 357-58 (1939).

¹⁸⁷ 52 T.C. 885 (1969), *aff'd*, 441 F.2d 593 (5th Cir. 1971).

¹⁸⁸ 70 T.C. at 129 *quoting* *Rush v. Commissioner*, 441 F.2d 598 (5th Cir. 1971).

¹⁸⁹ *Id.* at 130.

¹⁹⁰ *Id.* at 127.

¹⁹¹ *Id.* at 130.

completion of the sale.¹⁹² To rebut the Service's position that the petitioner had control over the proceeds from the sale of the stock, the court turned to the relevant Florida law.¹⁹³ In the court's opinion, it was quite clear under Florida law that the trustee was under a duty to manage the corpus of the trust only in a manner to serve most efficiently the interests of the trust's beneficiaries.¹⁹⁴ Thus, the decision to sell the stock was made by the trustee in accordance with his fiduciary duty owed to the trust's beneficiaries.¹⁹⁵ The present facts showing an informal understanding between the trustee and the individual taxpayer is not controlling. When the original seller has pre-arranged with a third party for the ultimate resale or transfer of the proceeds back to the original seller, only then will the court deny the taxpayer the right to reap the tax advantages under the installment sales method.¹⁹⁶

Several other cases relied on by the Service were distinguished by the court. In *Griffiths v. Commissioner*,¹⁹⁷ the United States Supreme Court denied installment sales treatment because the intermediary was a corporation wholly controlled by the seller thereby allowing the seller to retain direct control of the proceeds. In contrast, the trusts in the present case were controlled by the trustee, not the taxpayer. *Wrenn v. Commissioner*¹⁹⁸ also involved a transaction involving family members dealing with mutual funds. A husband and wife entered into a sale of securities in which all securities were transferred to the wife at the date of the sale but the payments were to be made in monthly installments over a fifteen-year period.¹⁹⁹ In order for the wife to meet the payments under the installment obligation, the wife invested the proceeds in mutual funds.²⁰⁰ Because interspousal sales are subject to close judicial scrutiny, the court in *Wrenn* found that there was no independent purpose for entering into the transaction.²⁰¹ *Pityo* was distinguished because of the existence of financial presence of economic benefits.²⁰² Another case distinguished by the court was *Williams v. United States*.²⁰³ The taxpayers had sold standing timber to a purchaser who was

¹⁹² *Id.* at 131.

¹⁹³ *Id.* at 132.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at 132, citing *Brown v. Commissioner*, 180 F.2d 926 (3rd Cir. 1950), cert. denied, 340 U.S. 814 (1950); *Oakes v. Commissioner*, 44 T.C. 524, 529 (1965); *Felix v. Commissioner*, 21 T.C. 794, 804 (1954).

¹⁹⁶ *Id.* at 132.

¹⁹⁷ 308 U.S. 355 (1939).

¹⁹⁸ 67 T.C. 576 (1976).

¹⁹⁹ *Id.* at 577-78.

²⁰⁰ *Id.* at 578.

²⁰¹ *Id.* at 583.

²⁰² 70 P-H T.C. at 133.

²⁰³ 219 F.2d 523 (5th Cir. 1955).

willing to pay the full purchase price.²⁰⁴ But at the urging of the seller, the purchaser placed four-fifths of the price in escrow with the escrow agreement providing for installments over a four-year period.²⁰⁵ Due to the fact that the proceeds were constructively received by the taxpayers, the taxpayers in this particular situation were not entitled to installment sales treatment.²⁰⁶

8.00 Procedure

8.01 Bankruptcy Reform Act of 1978

Under the Bankruptcy Reform Act of 1978,²⁰⁷ special tax provisions were codified to deal with the interrelationships between federal, state, and local income taxes and bankruptcy. However, the Act provides that if there is a conflict between the Reform Act and the Internal Revenue Code, the Internal Revenue Code is controlling.²⁰⁸

Under Section 346 (b) (1)²⁰⁹ a new tax entity known as the "estate" is created in Chapter 7 and Chapter 11 bankruptcy cases and is taxed similar to a decedent's estate under Section 641²¹⁰ of the Internal Revenue Code. Under these provisions the individual cannot be taxed himself but only through the estate. These provisions do not apply in a Chapter 13 proceeding.²¹¹ A trustee for a decedent's estate is required to give the Internal Revenue Service notice of his appointment.²¹²

Though the income is to be determined in the same manner as the tax of the estate, there are some noticeable changes. A partner is accountable to the estate for income tax purposes for any gain or loss from property distributed from a partnership after the commencement of the case.²¹³ Present law is not clear as to whether the individual partner or the partnership must report the gain or loss from a distribution of property from a partnership after the commencement of the case.²¹⁴ Secondly, the accounting method of the debtor shall be the same as immediately before the commencement of the case.²¹⁵ Prior to the Bankruptcy Reform Act of 1978, the trustee could

²⁰⁴ *Id.* at 524 n.2.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 527.

²⁰⁷ Pub. L. No. 95-598, 92 Stat. 2549 (1978).

²⁰⁸ 11 U.S.C. § 346(a) (1978).

²⁰⁹ *Id.* at § 346(b)(1).

²¹⁰ INT. REV. CODE of 1954, § 641.

²¹¹ 11 U.S.C. § 346(d).

²¹² INT. REV. CODE of 1954, § 6036.

²¹³ 11 U.S.C. § 346(b)(1).

²¹⁴ PRACTICING LAW INSTITUTE, BANKRUPTCY REFORM ACT OF 1978 at 271 (1978).

²¹⁵ 11 U.S.C. § 346(b)(3).

elect the method of accounting.²¹⁶ The trustee can choose to report on a calendar or fiscal year.²¹⁷

A significant change is found in Section 346 (c) (1) stating that a corporation and partnership continue in existence after the commencement of a bankruptcy case. Regarding a partnership, this is a drastic change from the current position in which the trustee files a form 1041 on behalf of the partnership and bankrupt partners.²¹⁸ The Reform Act would require the trustee to complete and file form 1065.²¹⁹ More importantly, under Sections 728 (c) and 728 (d), respectively, the Service cannot use exempt property of partners to satisfy claims against the partnership nor could the partner accept a refund on behalf of the partnership. The refund becomes an asset of the estate under codified procedural requirements and the trustee for a corporation or a partnership in a bankruptcy proceeding is required under Section 364 (c) (2) to file a tax return thereon. However, the Internal Revenue Code is more specific in requiring the trustee to pay any legally owing taxes.²²⁰ In contrast, an individual debtor²²¹ is no longer required to complete his own return for the whole calendar year²²² but in Chapter 7²²³ and Chapter 11,²²⁴ only at the date of the order of relief preceding the tax. The tax year for a corporation or a partnership ends at the commencement of the case in Chapter 7²²⁵ and Chapter 11²²⁶ proceedings.

The last major attempt by Congress to codify bankruptcy procedure is Section 1146 (d). The statute permits any proponent of a reorganization plan in a Chapter 11 proceeding to request a government finding concerning the tax consequences of the reorganization. The bankruptcy court may, in the case of an actual controversy, issue a declaratory judgment on the tax effects. The declaratory judgment is to be issued on the earlier of the date of the government response to the proponent's request on the tax effects of the plan²²⁷ or 270 days after the proponent has issued the written request.²²⁸ However, the right of the bankruptcy court to issue a declaratory judgment conflicts with Internal Revenue Code Section 7421. Under para-

²¹⁶ Rev. Rul. 72-387, 1972-2 CUM. BULL. 632.

²¹⁷ PRACTICING LAW INSTITUTE, *supra* note 214, at 274.

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ INT. REV. CODE of 1954, § 6151(a).

²²¹ 11 U.S.C. § 101(12).

²²² Rev. Rul. 72-387, 1972-2 CUM. BULL. 632.

²²³ 11 U.S.C. § 728(a).

²²⁴ *Id.* at § 1146(a).

²²⁵ *Id.* at § 728(b).

²²⁶ *Id.* at § 1146(b).

²²⁷ *Id.* at § 1146(d)(1).

²²⁸ *Id.* at § 1146(d)(2).

graph one of subsection (b) of Section 7421, the bankruptcy court is clearly prohibited from assessing or collecting any amount of federal tax liability. Since Section 1146 of the Bankruptcy Reform Act does not specifically defer to the Internal Revenue Code as Section 346 does, court cases determining the applicability of 1146 (d) will likely occur.

Under the present Bankruptcy Act, secured debts are to be first satisfied out of the bankrupt's estate. The unsecured debts are to be satisfied next out of the estate. Among unsecured creditors, the present Bankruptcy Act provides that certain unsecured creditors are to be paid in full from the dividends of the estate before any other unsecured creditors are to receive dividends.²²⁹

Within the class of debts having priority over those of the general creditors, there is a priority of claims regardless of any priority imposed by state law. Costs and expenses of administration rank first in priority, which include principally all actual and necessary costs of preserving the estate after the filing of the petition, filing fees paid by creditors in involuntary cases or by persons other than the bankrupt in involuntary cases, and reasonable costs and expenses for property transferred by the bankrupt for the benefit of the estate.²³⁰ Second in priority among these claims are claims up to \$600 of income by a wage earner within a period of three months prior to the commencement of the proceedings.²³¹ Under Section 64 (a) (3) of the Bankruptcy Act, the third priority involves the costs and expenses incurred by creditors opposing a discharge, a Chapter 13 plan, or arrangement and expenses for obtaining evidence to be used by the government in convictions under Chapter 9 of Title 18 of the United States Code.²³² The fourth priority involves taxes legally owing and due to the United States government, state government, or any municipal subdivision²³³ within three years preceding bankruptcy or where one of the exceptions dealing with taxes under Section 17 (a) (1) applies.²³⁴ The last priority includes debts other than taxes owed to the United States and landlords' liens specifically provided for by state law.²³⁵

The Bankruptcy Reform Act of 1978, effective generally October 1, 1979, with the new bankruptcy system taking effect in April 1, 1984,²³⁶

²²⁹ *Id.* at § 104.

²³⁰ *Id.* at § 104(a)(1).

²³¹ *Id.* at § 104(a)(2).

²³² *Id.* at § 104(a)(3).

²³³ *Id.* at § 104(a)(4).

²³⁴ *Id.* at § 35(a)(1).

²³⁵ *Id.* at § 104(a)(5).

²³⁶ *Id.* at § 402.

changed the law as to priorities among certain unsecured creditors. The first priority under the new law is given to administration expenses.²³⁷ The second among the priorities is a creditor's claim which arises in an involuntary case during the ordinary course of the debtor's business after the filing of the petition.²³⁸ Wage claims including vacation, severance, and sick leave pay with a new upper limit of \$2000 are the third priority.²³⁹ The fourth priority includes employee fringe benefits such as claims for contributions to employee benefit plans including pension, health, or life insurance plans arising 180 days before the filing of the petition.²⁴⁰ The maximum amount under the claim is \$2000 times the number of employees under the plan.²⁴¹ The Reform Act created a fifth priority for consumer creditors which is limited to \$900 for the purchase of personal services, the purchase of property or rental of property.²⁴²

The last of the priorities include state and federal taxes.²⁴³ The priority for income taxes is limited to taxes due within three years of the filing of the petition.²⁴⁴ Other taxes granted priority among unsecured creditors include property taxes, employment and withholding taxes, excise taxes, customs duties, and tax penalties which represent a pecuniary loss.²⁴⁵ Taxes other than income taxes are not granted the priority for three years after the commencement of bankruptcy proceedings.

Priority claims are paid first in a liquidation case²⁴⁶ and under a case in Chapter 11²⁴⁷ or Chapter 13²⁴⁸ proceedings. Therefore, the Bankruptcy Reform Act has changed the Service's favorable position among the priorities in collection of claims from the debtor's estate into a position not as strong as under present law.

The present law provides that taxes, *i.e.*, federal, state or local, legally owing and due for less than three years are nondischargeable.²⁴⁹ The determination of the tax liability of the debtor is made by the bankruptcy court, provided that the tax issue has not been contested before or adjudicated by a court

²³⁷ *Id.* at § 507(a)(1).

²³⁸ *Id.* at § 507(a)(2).

²³⁹ *Id.* at § 507(a)(3).

²⁴⁰ *Id.* at § 507(a)(4).

²⁴¹ *Id.* at § 507(a)(H)(A).

²⁴² *Id.* at § 507(a)(5).

²⁴³ *Id.* at § 507(a)(6).

²⁴⁴ *Id.* at § 507(a)(6)(H)(i).

²⁴⁵ *Id.* at § 507(a)(b)(B)-(G).

²⁴⁶ *Id.* at § 726(a)(1).

²⁴⁷ *Id.* at § 1129(a)(9).

²⁴⁸ *Id.* at § 1322(a)(2).

²⁴⁹ *Id.* at § 35(a)(1).

of competent jurisdiction prior to the filing of the bankruptcy petition, both under present law²⁵⁰ and the Bankruptcy Reform Act.²⁵¹

Despite the recommendations that all taxes legally owing and due for more than a year are to be discharged, Congress adopted a varied approach as to the time periods for dischargeability of taxes. Federal and state income taxes, employment taxes and excise tax become dischargeable three years after becoming legally owing and due.²⁵² Property taxes and customs duties become dischargeable one year after becoming legally owing and due.²⁵³ It is not necessary for the government under Section 523 (a) (1) (A), regarding taxes receiving priority under Section 597 (a) (6), to file a claim to prevent the debt from becoming dischargeable.

Further, the Bankruptcy Reform Act incorporates the present law by retaining the exceptions to discharge without regard to a time limit under the conditions of fraud, late filing, or failure to file a tax return.²⁵⁴ The Bankruptcy Reform Act specifically did not remove the unlimited dischargeability of debts for failure of an officer to withhold various taxes as found in the present law.²⁵⁵ However, the new Act has appeared to remove the government's privilege to proceed against the exempt property on discharged tax debts for nondischargeable tax debts.²⁵⁶

Section 501 of the Bankruptcy Reform Act of 1978²⁵⁷ allows the taxable entity,²⁵⁸ the debtor,²⁵⁹ or the trustee²⁶⁰ to file a claim on behalf of any creditor. It is possible to construe Rule 303 of the Bankruptcy Rules to allow the the debtor-bankrupt to file a claim on behalf of the Internal Revenue Service.

As to the question of the determination of filed tax claims, Section 505 of the Bankruptcy Reform Act of 1978²⁶¹ allows the bankruptcy court to rule on the tax liability of the responsible party except for any tax, penalty, or addition that was adjudicated before the commencement of the case.²⁶² A second exception applies to the bankruptcy court making a determination of

²⁵⁰ *Id.* at § 11(a)(2)(A).

²⁵¹ *Id.* at § 505.

²⁵² *Id.* at § 523(a)(1)(A).

²⁵³ *Id.*

²⁵⁴ *Id.* at §§ 253(a)(B) & (C).

²⁵⁵ *Id.* at § 523(a)(1)(A).

²⁵⁶ *Id.* at § 35(a)(1)(e).

²⁵⁷ *Id.* at § 504.

²⁵⁸ *Id.* at § 501(b).

²⁵⁹ *Id.* at § 501(G).

²⁶⁰ *Id.*

²⁶¹ *Id.* at § 505.

²⁶² *Id.* at § 505(2)(A).

any refund to a debtor or estate.²⁶³ The court cannot make a finding regarding a refund until the earlier of 120 days after the trustee requests such refund from the government or a determination by the government of such a request.²⁶⁴

The trustee may always request a determination of any unpaid tax liability during the administration of the case by submitting a tax return to the proper governmental unit.²⁶⁵ If the return is not fraudulent or does not contain a material misrepresentation, then the debtor or any successor to the debtor is not liable after the payment of the taxes upon the fulfillment of certain conditions.²⁶⁶ One of the following conditions will suffice: the failure of the government to notify the trustee within sixty days after such request that examination will be done,²⁶⁷ the governmental unit does not complete the examination within 180 days of such request,²⁶⁸ the payment of the tax after hearing and notice by the court and governmental unit examination is completed,²⁶⁹ or upon the payment of the tax as determined by the governmental unit.²⁷⁰

8.02 Suits Against the IRS

The Eighth Circuit Court of Appeals, in a *per curiam* decision,²⁷¹ held that Sections 2680 (a) and (h)²⁷² of the Federal Tort Claims Act barred an accountant's claim against IRS agents for malicious prosecution, abuse of process and libel and slander. An accountant, Fay Anderson, had an office in LeMars, Iowa. In accordance with the IRS's Tax Preparer's Program, a program implemented to locate dishonest tax preparers, two IRS agents came to Anderson's office in February, 1973, and supplied him with manufactured income and expense statements.²⁷³ Anderson prepared their returns. A short time later, IRS agents revisited Anderson's offices. Anderson, after being advised of his rights, relinquished to the IRS agents 132 files.²⁷⁴ After carefully investigating the files, the IRS arrested Anderson for allegedly violating Section 7206(2)²⁷⁵ which prohibits willful aiding, assisting, procuring,

²⁶³ *Id.* at § 505(2)(B).

²⁶⁴ *Id.* at § 505(2)(B)(i).

²⁶⁵ *Id.* at § 505(b).

²⁶⁶ *Id.* at § 505(b)(1).

²⁶⁷ *Id.* at § 505(b)(1)(A).

²⁶⁸ *Id.* at § 505(b)(1)(B).

²⁶⁹ *Id.* at § 505(2).

²⁷⁰ *Id.* at § 505(3).

²⁷¹ *Anderson v. United States*, 548 F.2d 249 (8th Cir. 1977), *cert. denied*, 434 U.S. 819 (1977).

²⁷² 28 U.S.C. §§ 2680(a), (h) (1970).

²⁷³ 548 F.2d at 251.

²⁷⁴ *Id.*

²⁷⁵ *Id.*

counseling or advising the preparation of a false or fraudulent tax return. Upon hearing of Anderson's arrest, the local news media reported the event. At the preliminary hearing, however, the magistrate dismissed the criminal charges against Anderson.²⁷⁶

Anderson brought an action for invasion of privacy, wiretapping, and damage to business and reputation allegedly resulting from the negligent design and implementation of the Tax Preparer's Program.

Anderson contended that the provisions of the Federal Tort Claims Act barring any claim for an act or omission performed as a discretionary function or duty on the part of a federal agency, even if discretion was abused, did not apply in this particular case.²⁷⁷ The court found sufficient statutory support for the Tax Preparer's Program in Section 7206 (2) to dispel Anderson's assertion that the entire Tax Preparer's Program was unauthorized by statute and thus not within the purview of the Federal Tort Claims Act.²⁷⁸ Anderson argued alternatively that the IRS agents acted outside the regulations promulgated by the Service regarding the investigation of tax preparers for violations under Section 7206 (2). The court found that argument to be lacking for two reasons: 1) the complaint never contained the allegation and 2) the court would not allow relitigation of the district court's finding that the IRS agents were acting within their scope of authority.²⁷⁹

The third argument raised by Anderson was that the negligence complained of took place at the operational stage of the Tax Preparer's Program and not at the planning stage. The court entirely agreed with the district court's determination that the actions by IRS officials fell within the planning stage of the program and were classic examples of the type of decisions wherein policy factors are considered. As such, the court concluded that Anderson's claims were barred by the discretionary acts exception to the Federal Tort Claims Act.²⁸⁰

In conclusion, the court found no basis for Anderson's claim for recovery. In addition, the court ruled that Section 2680 (h)²⁸¹ of the Federal Tort Claims Act, barring claims against investigating agencies for assault, battery, false imprisonment, false arrest, abuse of process, or malicious prosecution would also prevent recovery for damages.²⁸²

The question now raised is whether a taxpayer has any recourse against

²⁷⁶ *Id.*

²⁷⁷ *Id.*

²⁷⁸ *Id.* at 252.

²⁷⁹ *Id.*

²⁸⁰ *Id.*

²⁸¹ 28 U.S.C. § 2680(h) (1970).

²⁸² 548 F.2d at 252.

the IRS for damages caused by publicity for wrongful arrests or action. The United States Supreme Court, in *Scheuer v. Rhodes*,²⁸³ removed the absolute immunity from liability granted government officials for damages resulting from actions with improper notices or with malice. The absolute immunity doctrine was replaced by the Court with a qualified immunity. A government official is protected under the qualified immunity doctrine upon a finding that at the time of the act or omission there existed reasonable grounds for the official to believe that his action was appropriate.²⁸⁴ In addition, the official must have acted in good faith.²⁸⁵

In *Mark v. Groff*,²⁸⁶ the Ninth Circuit Court of Appeals reversed a lower court's finding granting absolute immunity to IRS agents. The court remanded the proceedings to the district court to determine the scope of the agents' authority and whether the agents had acted in good faith. In *Mark*, the appellant claimed that the IRS agents maliciously, intentionally, and wantonly took certain actions to disrupt his tax preparation business and to cause him extreme emotional distress.

Recent cases have attempted to define more precisely the bounds of the qualified immunity accorded government officials. In *Brobeck v. Plasko*²⁸⁷ the taxpayer, the president of a car dealership, had signs posted on the premises warning that all officers of the law would be treated as trespassers. Two IRS agents, after investigating the 1970 and 1971 returns of the taxpayer, issued a summons pursuant to Section 7603²⁸⁸ to search the corporation's books and records. The taxpayer refused to cooperate and was incarcerated for failure to obey the summons. The taxpayer was ultimately released despite his rather doubtful explanation that he did not have custody of the summoned records. Thereupon, the taxpayer brought an action for trespass. The district court dismissed the suit holding that the agents acted in good faith and within the scope of their duties.²⁸⁹

The United States Supreme Court, in *General Motors Leasing Corp. v. United States*,²⁹⁰ held that the warrantless entry by Internal Revenue Service officers into the petitioner's corporate office violated the corporation's fourth amendment rights against invasion of privacy and unreasonable searches and seizures. The determination of whether the agents' actions fell within the

²⁸³ 416 U.S. 232 (1973).

²⁸⁴ *Id.* at 247.

²⁸⁵ *Id.* at 248.

²⁸⁶ 521 F.2d 1376 (9th Cir. 1975).

²⁸⁷ 34 Am. Fed. Tax R.2d 74-6010 (D.C.Pa. 1974).

²⁸⁸ INT. REV. CODE of 1954, § 7603.

²⁸⁹ 34 Am. Fed. Tax R.2d at 74-6011.

²⁹⁰ 429 U.S. 338 (1977).

qualified immunity standards set forth in *Scheuer* was not addressed by the Court, as the case was remanded for the determination of damages.

As a result of these decisions, a taxpayer can recover damages from IRS agents only when, considering all the relevant circumstances, the agents acted in bad faith and outside the scope of their duties.

8.03 Jury Awards

In *Rediker v. Chicago, Rock Island and Pacific Railroad Co.*,²⁹¹ an employee recovered \$450,000 from the railroad company under the Federal Employer's Liability Act²⁹² for the loss of a leg and other injuries sustained when he fell beneath the wheels of a railroad car on which he was coupling air hoses. The Kansas Court of Appeals affirmed the lower court's judgment on all issues including the trial court's prohibiting evidence of the impact of federal tax law upon the damages to be awarded.²⁹³

The court relied upon the Kansas Supreme Court's decision in *Spencer v. Eby Construction Co.*²⁹⁴ in excluding all evidence concerning the fact that the damage award would not be taxable to the plaintiff under the provisions of Section 104 (a) (2).²⁹⁵ The factors listed by the court in refusing such evidence included the complexity in the computation of the tax benefit, the fact that any mitigation of damages by the jury would nullify the legislative intent of giving an injured party a tax benefit, that income tax liability or savings is only a matter of concern between the injured plaintiff and the IRS, and that the amount of income tax on one's future earnings is too speculative to be utilized in determining damages.²⁹⁶

The United States Supreme Court denied certiorari²⁹⁷ in the case on constitutional grounds, in effect refusing to consider the railroad's argument that the failure to allow the employer under the Federal Employer's Liability Act to establish the impact of federal income tax on a jury award, while the employee was permitted to introduce speculative evidence as to damages, deprived the railroad of its property rights under the Due Process and Equal Protection Clauses of the United States Constitution. As a result of the Supreme Court's position of refusing to find a constitutional question, it would appear that the federal and individual state jurisdictions are left free to determine the correctness of charging or not charging the jury regarding the

²⁹¹ 1 Kan. App. 2d 581, 571 P.2d 70 (1977).

²⁹² 45 U.S.C. §§ 51-60 (1970).

²⁹³ 1 Kan. App. 2d at 581, 571 P.2d at 70.

²⁹⁴ 186 Kan. 345, 350 P.2d 19 (1960).

²⁹⁵ INT. REV. CODE of 1954, § 104(a)(2).

²⁹⁶ 1 Kan. App. 2d at 588, 571 P.2d at 76.

²⁹⁷ 435 U.S. 982 (1978).

exclusion of certain elements of a jury award from gross income under Section 104 (a) (2).

8.04 Duties of Tax Return Preparers

Under the 1976 Tax Reform Act, Congress set minimal levels of competence for income tax return preparers in order to protect the taxpayer from unqualified individuals. An income tax preparer is defined under Section 7701 (a) (36) (A)²⁹⁸ as a person who prepares a substantial part of a tax return or claim of refund for compensation, or one who employs one or more persons to prepare tax returns or claims for refunds. One is not considered an income tax return preparer merely by: 1) typing or reproducing the return;²⁹⁹ 2) preparing a return or refund for the employer by whom the person is regularly and continuously employed;³⁰⁰ 3) being a fiduciary preparing a return or claim for a refund for any trust or estate;³⁰¹ 4) preparing a claim for refund for a taxpayer in response to a notice of deficiency or in response to a waiver of restriction after the commencement of audit of a taxpayer or another taxpayer if the determination of the audit of the other taxpayer affects the tax liability of such taxpayer.³⁰²

Section 6109 (a)³⁰³ requires that the income tax preparer sign his name to the tax return and place his identifying number (social security number) and address on the tax return. A penalty of \$25 is assessed against the income tax preparer for failure to sign a return³⁰⁴ or furnish the identifying number.³⁰⁵ The income tax preparer's only defense to such assessment is to show that the failure to comply is due to reasonable cause and not because of willful neglect.

To insure the competence of the income tax return preparer, a preparer will be assessed a \$100 penalty for understating the taxpayer's liability through intentional, negligent,³⁰⁶ or willful disregard³⁰⁷ of the Code. The taxpayer's liability for the understatement of tax liability still remains in full effect.

After a tax return is completed, the income tax return preparer, under Section 6107,³⁰⁸ must give a copy of the return to the taxpayer and must keep

²⁹⁸ INT. REV. CODE OF 1954, § 7701(a)(36)(A).

²⁹⁹ *Id.* at § 7701(36)(B)(i).

³⁰⁰ *Id.* at § 7701(36)(B)(ii).

³⁰¹ *Id.* at § 7701(36)(B)(iii).

³⁰² *Id.* at § 7701(36)(B)(iv).

³⁰³ *Id.* at § 6109(a).

³⁰⁴ *Id.* at § 6695(b).

³⁰⁵ *Id.* at § 6695(c).

³⁰⁶ *Id.* at § 6694(a).

³⁰⁷ *Id.* at § 6694(b).

³⁰⁸ *Id.* at § 6107.

a record of the name and taxpayer identification number of the taxpayer or a copy of his return. Failure to furnish the taxpayer with a copy of the tax return will result in a penalty of \$25 unless the preparer shows that the failure is due to reasonable cause and not due to willful neglect.³⁰⁹ The failure of the preparer to retain a copy of the return or a list of the names and taxpayer identification numbers of the taxpayers will result in a penalty of \$50 for each failure, up to a maximum penalty of \$25,000, unless the preparer can show that the failure is due to reasonable cause and not willful neglect.³¹⁰

The Tax Reform Act of 1976 also placed a legal duty on the employer of income tax return preparers to file an information return. Section 6060 (a)³¹¹ requires that the information return contain the name of each preparer employed, the taxpayer identifying number of each preparer, and the place of work of each employed preparer. The IRS, pursuant to Sections 6695 (e) (1)³¹² and 6695 (e) (2)³¹³ respectively, will assess a penalty of \$100 for failure to file an information return and a \$5 penalty for failure to set forth a required item on the information return. As in all penalties assessed for failure of the income tax preparer to follow statutory commands, the preparer must pay the penalty unless it is shown that the failure is due to reasonable cause and not willful neglect.

Two other significant statutory duties are imposed on income tax preparers. The tax preparer is not allowed to endorse or negotiate a taxpayer's refund check and any violations will result in a \$500 penalty being assessed against the preparer.³¹⁴ The last significant duty imposed on the income tax preparer is to not disclose any information furnished to him or for him in connection with preparation of return or declaration.³¹⁵ The unauthorized disclosure or use of information by preparers could result in a criminal penalty up to \$1,000 and imprisonment up to one year or both, together with the costs of prosecution.³¹⁶

Though the Code prescribes a specified conduct for income tax preparers, the IRS has implemented modifications on the duties of tax preparers. Revenue Announcement 78-91³¹⁷ forbids employers of income tax return preparers to be assessed penalties for failure to provide their employees'

³⁰⁹ *Id.* at § 6695(a).

³¹⁰ *Id.* at § 6695(d).

³¹¹ *Id.* at § 6060(a).

³¹² *Id.* at § 6695(e)(1).

³¹³ *Id.* at § 6695(e)(2).

³¹⁴ *Id.* at § 6695(f).

³¹⁵ *Id.* at § 7216.

³¹⁶ *Id.* at § 7216(a).

³¹⁷ Rev. Announcement 78-91, 1978-23 INT. REV. BULL. 40.

social security numbers on federal income tax returns and on claims for refunds filed before June 30, 1978.

Another recent release³¹⁸ of the IRS states that for returns filed prior to January 1, 1979, no penalties will be assessed against income tax preparers for failure to compute and report the additions to the tax imposed under Sections 6654³¹⁹ and 6655³²⁰ for failure to pay estimated tax. Section 1.6694-1 (d)³²¹ of the Regulations clearly states that the failure of the preparer to compute and report additions under the estimated tax sections of the Code will result in an understatement of tax liability in violation of Section 6694(e)³²² for intentional or negligent disregard of the rules and regulations. However, due to the confusion in the practitioner community, the IRS will allow the aforementioned grace period.

Revenue Ruling 77-184³²³ states that an income tax preparer who also operates a check cashing agency at the same address will not be in violation of Section 6695 (f)³²⁴ when cashing income tax refund checks that are properly endorsed by the payee even though the checks are cashed for individuals for whom the preparer had prepared returns. Without this ruling, the income tax preparer, despite the most innocent intentions, would have been assessed a penalty under Section 6695 (f) of \$500 for each check cashed.

The latest clarification by the IRS as to the Code sections governing the income tax return preparer is Revenue Ruling 78-245.³²⁵ Under Revenue Ruling 78-245, the period of limitations on assessments of income tax return preparer penalties may be extended under Section 6501 (c) (4).³²⁶ Though Section 6501 (c) (4) specifically refers to taxes, Section 6659 (a) (2)³²⁷ provides that any reference to tax in the Code shall be deemed to include penalties in Chapter 68 of the Code. All of the penalties that are assessable against income tax return preparers are found in Chapter 68.

8.05 Elimination of District Conference

In Revenue Proclamation 7809,³²⁸ the IRS announced that the District

³¹⁸ Rev. Release 1980 (April 3, 1978).

³¹⁹ INT. REV. CODE of 1954, § 6654.

³²⁰ *Id.* at § 6655.

³²¹ Treas. Reg. § 1.6694-1(d).

³²² INT. REV. CODE of 1954, § 6694(e).

³²³ Rev. Rul. 77-184, 1977-1 CUM. BULL. 407.

³²⁴ INT. REV. CODE of 1954, § 6695(f).

³²⁵ Rev. Rul. 78-245, 1978-1 CUM. BULL. 436.

³²⁶ INT. REV. CODE of 1954, § 6501(c)(4).

³²⁷ *Id.* at § 6659(a)(2).

³²⁸ Rev. Proc. 78-9, 1978-1 CUM. BULL. 563.

Conference would be eliminated in order to make administrative appeals procedures more effective. Another underlying purpose for modifying the procedure was to achieve an earlier development and disposition of docketed cases.

Regional counsel now has exclusive jurisdiction over any case docketed in the Tax Court upon the fulfillment of one of the following conditions: 1) if the notice of deficiency, liability or other determination was issued by the Appellate Division;³²⁹ 2) if the notice of deficiency, liability or other determination was issued after an appellate consideration by Employee Plans Exempt Organizations function;³³⁰ or 3) if the case was docketed under Code Sections 6110 (public inspection of written determinations) or 7477 (declaratory judgments relating to transfers of property from the United States).³³¹ The Appellate Division will have exclusive *settlement* jurisdiction over any case docketed in the Tax Court for a period of four months commencing at the time the Appellate Division receives the case from the chief counsel.³³² The Appellate Division's exclusive settlement jurisdiction will exist on the condition that the statutory notice of deficiency or liability was issued by any District Director of the IRS or by the Director of International Operations.³³³

Within forty-five days of the receipt of the case, the Appellate Division will arrange a settlement conference.³³⁴ The Appellate Division has the authority to settle less than all issues in the case and to refer the unsettled issues to the regional counsel for disposition.³³⁵ After the four month period of settlement jurisdiction by the Appellate Division, the regional counsel will have exclusive authority to dispose of the case.³³⁶

However, regional counsel may extend the Appellate Division's settlement jurisdiction for a period not to exceed sixty days, but in no event beyond the date of the receipt of a trial calendar or trial status order upon which the case appears.³³⁷ Any further extensions require the personal approval of the regional counsel and it must be established that the probability of settlement of the case in its entirety by the Appellate Division clearly outweighs the need to commence trial preparation.³³⁸

When regional counsel obtains sole jurisdiction over the case, it will

³²⁹ *Id.* at 563, § 1.

³³⁰ *Id.* at 563, § 1.

³³¹ *Id.* at 563, § 2.01.

³³² *Id.* at 563, § 2.02.

³³³ *Id.*

³³⁴ *Id.*

³³⁵ *Id.*

³³⁶ *Id.* at 563, § 2.03.

³³⁷ *Id.*

³³⁸ *Id.* at 563, § 2.04.

acquire the facts necessary for the development of the case through informal conferences and discovery proceedings.³³⁹ The Appellate Division will make available files and information for the regional counsel to reply to any request made by the court or take any action "in the best interests of the Government."³⁴⁰

Before counsel may consider settlement negotiations, the case must be fully developed and the regional counsel must have evaluated the position of the IRS as to litigation.³⁴¹ Counsel is also required to solicit the views of the Appellate Division in cases designated by the Appellate Division before making an offer of settlement.³⁴² Any objection by the Appellate Division to an offer for settlement made by counsel must be expressed with fifteen days.³⁴³ The chief counsel may, by appropriate order, require review by the regional counsel or the chief counsel, of counsel settlements of certain cases.³⁴⁴

If the Appellate Division disagrees with a proposed settlement it may protest the settlement and require the settlement to be reviewed by the regional counsel.³⁴⁵ In this instance, the Appellate Division must support its position and its view of an acceptable settlement by a memorandum.³⁴⁶ The regional counsel's decisions in these protest cases are final.³⁴⁷

When issues in docketed and nondocketed cases are pending before the Appellate Division and such issues are related to issues in cases in which counsel has sole jurisdiction, the settlement offer must be accepted by both counsel and the Appellate Division.³⁴⁸ Where a case is docketed in the Tax Court under Code Sections 6110 or 7477, the assistant commissioner and the deputy chief counsel will have joint settlement jurisdiction until brief due dates are set or until the first day the case appears on the trial calendar, whichever is earlier. Past this point, regional counsel has sole settlement jurisdiction.³⁴⁹

These new rules concerning appellate and settlement procedures will be applicable to all cases docketed with the Tax Court after June 30, 1978.³⁵⁰ The new procedure will also be applicable to cases pending in the Tax Court

³³⁹ *Id.* at 563-64, § 2.05.

³⁴⁰ *Id.* at 564, § 2.06.

³⁴¹ *Id.* at 564, § 2.07.

³⁴² *Id.* at 564, § 2.08.

³⁴³ *Id.* at 564, § 2.09.

³⁴⁴ *Id.* at 564, § 2.08.

³⁴⁵ *Id.* at 564, § 2.09.

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ *Id.* at 564, § 2.12.

³⁴⁹ *Id.* at 564, § 2.13.

³⁵⁰ *Id.* at 564, § 3(A).

on June 30, 1978, if the following circumstances exist: 1) the notice of deficiency was issued by either the District Director, or the Director of International Operations, or the Director of a Service Center or 2) a settlement conference has not been held by the Appellate Division prior to July 1, 1978.³⁵¹ For any cases pending in Tax Court on June 30, 1978, that do not fall in the above categories, the procedures specified in Revenue Proclamation 60-78³⁵² will continue to be applied,³⁵³ except that the sole authority to dispose of cases will rest in counsel at the earlier of either the date of receipt of the trial calendar on which the case is posted,³⁵⁴ or the date on which appellant and counsel conclude settlement negotiations without final disposition of the case.³⁵⁵ These new rules are to be followed in all cases by July 1, 1979.³⁵⁶

Effective July 2, 1978, regional counsel has been assigned responsibility for all refund litigation, in addition to the Tax Court litigation.

8.06 Summons Authority — Third Party Records

The United States Supreme Court gave a split but affirmative answer to the question “[w]hether an internal revenue summons may properly be issued to obtain third-party records in aid of an administrative investigation conducted by the Internal Revenue Service to determine whether it should recommend to the Department of Justice that a taxpayer be prosecuted for criminal tax violations.”³⁵⁷ In *United States v. LaSalle National Bank*,³⁵⁸ the Court lessened the likelihood of intervention concerning administrative summonses “issued in good faith and prior to a recommendation for criminal prosecution”³⁵⁹ and gave the Service increased latitude in the issuance and defense of summonses under Code Section 7602.³⁶⁰

The terms “good faith” and “recommendation for criminal prosecution” have been a source of controversy since their inclusion in the holding of *Donaldson v. United States*.³⁶¹ In its opinion in *LaSalle*, the Seventh Circuit

³⁵¹ *Id.* at 564, § 3(B).

³⁵² Rev. Proc. 60-78, 1960-2 CUM. BULL. 988.

³⁵³ Rev. Proc. 78-9, 1978-1 CUM. BULL. at 564, § 3(c).

³⁵⁴ *Id.* at 564, § 3(c)(.01).

³⁵⁵ *Id.* at 564, § 3(c)(.02).

³⁵⁶ *Id.* at 564, § 3(c)(.03).

³⁵⁷ Petitioner's Brief for certiorari at 2, *United States v. LaSalle Nat'l Bank*, 98 S. Ct. 2357 (1978).

³⁵⁸ 98 S. Ct. 2357 (1978).

³⁵⁹ *Donaldson v. United States*, 400 U.S. 517, 536 (1971).

³⁶⁰ INT. REV. CODE OF 1954, § 7602.

³⁶¹ 400 U.S. 517, 536 (1971).

found the Third,³⁶² Sixth,³⁶³ Ninth,³⁶⁴ and District of Columbia³⁶⁵ Circuits generally in support of permitting a "criminal purpose" defense to succeed when challenging a summons under Section 7602.³⁶⁶ The "good faith" requirement of *Donaldson* was found lacking when a summons was issued by the Service solely in aid of anticipated, but not yet "recommended," criminal prosecution.³⁶⁷

The Supreme Court relied on its prior decision of *United States v. Powell*³⁶⁸ to define the elements of good faith necessary for IRS summons authority. "[The Service] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed. . . ."³⁶⁹ Although alleged to have been issued solely for criminal discovery purposes,³⁷⁰ the summons was ruled as having been issued in good faith under *Powell*.³⁷¹

The Court noted that the Service cannot try its own prosecutions, but depends upon the Department of Justice to perform criminal litigation.³⁷² Since no recommendation other than one to the Justice Department could result in criminal prosecution, and since one had not been made, the *Donaldson* "recommendation" defense was ruled nonapplicable.³⁷³

The "criminal purpose" shield of *Donaldson* has been effectively stripped from the taxpayer by *LaSalle*. Strict interpretation by a bare majority has made a successful challenge of an administrative summons nearly unattainable.

8.07 Summons — Attorney-Client Privilege

The Sixth Circuit Court of Appeals in *United States v. Joseph*,³⁷⁴ enforced the Internal Revenue Service's right to require an attorney to produce, pursuant to the summons power of Section 7602,³⁷⁵ corporate records en-

³⁶² *United States v. McCarthy*, 514 F.2d 368 (3d Cir. 1975).

³⁶³ *United States v. Weingarden*, 473 F.2d 454 (6th Cir. 1973).

³⁶⁴ *United States v. Zack*, 521 F.2d 1366 (9th Cir. 1975).

³⁶⁵ *United States v. Wall Corp.*, 475 F.2d 893 (D.C. Cir. 1972).

³⁶⁶ 554 F.2d 302, 306-08 (7th Cir. 1977). The Supreme Court noted the importance of settling the differences of opinions among the courts of appeal concerning the scope of summons authority. 98 S. Ct. at 2362 n.6.

³⁶⁷ 554 F.2d at 308-09.

³⁶⁸ 379 U.S. 48 (1964).

³⁶⁹ 98 S. Ct. at 2366, citing 379 U.S. at 57-58.

³⁷⁰ 98 S. Ct. at 2360.

³⁷¹ *Id.* at 2368.

³⁷² *Id.* at 2365.

³⁷³ *Id.* at 2368.

³⁷⁴ 560 F.2d 742 (6th Cir. 1977).

³⁷⁵ INT. REV. CODE of 1954, § 7602.

trusted to the attorney by his client. A special agent had requested the corporate records from the attorney's client in connection with a tax investigation of a third party who had allegedly violated the federal gambling statutes. The attorney contended that the refusal of the IRS to give any guarantee that the information would not be used in a criminal tax prosecution and the attorney-client privilege prevented the court from enforcing the summons.³⁷⁶

The court found on the critical issue of good faith that the summons was issued in good faith based on the statements of state law enforcement officials and confidential informants.³⁷⁷ In determining that the summons was utilized only to gain relevant data on the tax liability of a third party, the court concluded that the test of issuing a summons only in good faith and prior to recommendation for criminal prosecution, as announced in *Donaldson v. United States*,³⁷⁸ had been met.

The attorney relied heavily on the Sixth Circuit's decision in *United States v. Henry*³⁷⁹ where the court found that the IRS acted in bad faith in issuing a summons to an attorney. The court, besides distinguishing *Henry* from the present case on the issue of good faith, based its determination in part on the fact that corporate records were involved.³⁸⁰ The court noted that it is well established that a corporation may not claim a privilege against self-incrimination, nor may a corporate officer refuse to produce records of the corporation on fifth amendment grounds.³⁸¹

The attorney's contention that the summons violated the attorney-client privilege was dispelled on the strength of *Fisher v. United States*.³⁸² The court noted that the nature of the materials summoned, corporate records, rebutted the argument.³⁸³ The court emphasized that even though the attorney was an agent of the taxpayer, the taxpayer was not compelled to do anything and, therefore, the taxpayer's fifth amendment privileges were not violated by the enforcement of the summons directed toward the attorney.³⁸⁴

9.00 Inventory

10.00 Pension, Profit-Sharing and Stock Ownership Plans

³⁷⁶ 560 F.2d at 743-44.

³⁷⁷ *Id.* at 744.

³⁷⁸ 400 U.S. 534 (1971).

³⁷⁹ 491 F.2d 702 (6th Cir. 1974).

³⁸⁰ 560 F.2d at 746.

³⁸¹ *Id.* at 746, citing *Wilson v. United States*, 221 U.S. 361, 382-85 (1911); *United States v. Peter*, 479 F.2d 147, 149 (6th Cir. 1973).

³⁸² 425 U.S. 391 (1976).

³⁸³ 560 F.2d at 747.

³⁸⁴ *Id.* at 746-47, citing *Couch v. United States*, 409 U.S. 322 (1973).

11:00 Corporations

11.01 Brother-Sister Corporations

Circuit by circuit, the Tax Court's definition of brother-sister controlled corporation groups is being reviewed and reversed. Nevertheless, the latest ruling, *Delta Metalforming Co., Inc.*,³⁸⁵ holds with its since reversed predecessors and favors the taxpayer by permitting an exemption to Code Section 1563 (a) (2),³⁸⁶ thus allowing him the corporation's multiple tax benefits rather than restrictions under Section 1561 (a).³⁸⁷ However, if the Fifth Circuit follows the lead of the Fourth and Eighth, this taxpayer victory will be short lived on appeal.

The sole example of brother-sister corporations found in the Treasury Regulations is as follows:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations					Identical Ownership
	P	Q	R	S	T	
A	60%	60%	60%	60%	100%	60%
B	40%	—	—	—	—	—
C	—	40%	—	—	—	—
D	—	—	40%	—	—	—
E	—	—	—	40%	—	—
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>60%</u>

Corporations P, Q, R, S, and T are members of a brother-sister controlled group.³⁸⁸

In this example, four of the individuals have no voting power in four corporations each.

In *Delta*, only one individual lacked voting power, and this was true for only one corporation.³⁸⁹ Inclusion of that person's interests was necessary to satisfy the brother-sister requirement that "at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corpo-

³⁸⁵ 1978 P-H TAX CT. MEM. ¶ 78,354 (September 7, 1978).

³⁸⁶ INT. REV. CODE OF 1954, § 1563(a)(2).

³⁸⁷ *Id.* at § 1561(a).

³⁸⁸ Treas. Reg. § 1.1563-1(a)(3), ex. 1.

³⁸⁹ 1978 P-H TAX CT. MEM. at 1474.

ration" had to be possessed by five or fewer persons.³⁹⁰ The Service contended that this person's interests should be included, with Delta losing surtax exemption benefits.³⁹¹ Delta countered that the brother-sister relationship required that each stockholder be considered as owning shares in all companies concerned.³⁹²

By holding for the taxpayer, the court has repeated its statement that the Treasury Regulation example of a brother-sister corporation is incorrect.³⁹³ The Tax Court requires more than the mechanics of Section 1563 (a) (2); it requires some interest to be held by all parties in all parts of a controlled group. This requirement exists for the taxpayer who can take advantage of it, at least until all the circuits or the Supreme Court states otherwise.

11.02 Unreasonable Accumulation of Earnings — Bardahl Formula Questions

Under the 1965 "*Bardahl*"³⁹⁴ formula," the Internal Revenue Service established guidelines to determine the sufficiency of liquid assets to meet corporate operating costs.³⁹⁵ Assets over and above the calculated amount are assessed for additional taxation under Code Section 531 as unreasonable accumulations of earnings.³⁹⁶ As predicted by John Chommie, *Bardahl* was merely an incipient stage of development in this field.³⁹⁷ The Tenth Circuit has recently elaborated on the formula in *Central Motor Co. v. United States*,³⁹⁸ holding that a finance company's credit cycle may be considered in reducing its operating cycle, thus reducing the amount of working capital required to meet the costs of operation.³⁹⁹

Section 531 imposes a tax of 27½% on accumulated taxable income not exceeding \$100,000 and 38½% on that in excess of \$100,000.⁴⁰⁰ Its purpose is to prevent avoidance of income tax by prompting the distribution to shareholders rather than retention by corporations of earnings and

³⁹⁰ INT. REV. CODE of 1954, § 1551(b).

³⁹¹ 1978 P-H TAX CT. MEM. at 1474.

³⁹² *Id.* INT. REV. CODE of 1954, § 1561(a)(2) states to "[take] into account the stock ownership of each such person . . ." but the meaning is disputable.

³⁹³ See also *Fairfax Auto Parts of N. Va. v. Commissioner*, 65 T.C. 798 (1976), *rev'd*, 548 F.2d 501 (4th Cir. 1977); *T.L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 (8th Cir. 1977), reversing a Memorandum Opinion of the Tax Court.

³⁹⁴ *Bardahl Mfg. Corp.*, 34 P-H TAX CT. MEM. ¶ 65,200 (July 23, 1965).

³⁹⁵ *Id.* at 1140-43.

³⁹⁶ INT. REV. CODE of 1954, § 531.

³⁹⁷ J. CHOMMIE, FEDERAL INCOME TAXATION 619 (2d ed. 1973).

³⁹⁸ 583 F.2d 470 (10th Cir. 1978).

³⁹⁹ *Id.* at 481-83.

⁴⁰⁰ INT. REV. CODE of 1954, § 531.

profits.⁴⁰¹ The *Bardahl* decision found that an operating cycle “[consisted] of the period of time required to convert cash into raw materials, raw materials into an inventory of marketable . . . products, the inventory into sales and accounts receivable, and the period of time required to collect . . . outstanding accounts. . . .”⁴⁰² By dividing the year by the operating cycle and multiplying that number times the operating costs per cycle, one may calculate the total amount of liquid assets annually necessary for all operations.

The refinement in *Central Motors* is an application of the above, with consideration being given to words contained in the later case of *Bardahl International Corp.*⁴⁰³ This case called for:

consideration [to] be given . . . to the length of time . . . accounts payable for the purchase of inventory remained unpaid; in other words, the average period of credit extended [by one’s supplies] . . . [T]he length of the cycle is reduced by the lag between the time [one] receives the inventory and has to pay for it.⁴⁰⁴

The Tenth Circuit has laid the way for reduction of the cycle contingent on submission of sufficient evidence to support the contention that the corporation was permitted to defer payments.⁴⁰⁵ However, a proposed reduction of the operating cycle was found unacceptable due to the general nature of the government’s contention that thirty days was *Central Motors*’ average credit period.⁴⁰⁶ Specific evidence of the actual period for which credit payments were deferred is required. On remand, the operating cycle of the company will be determined through use of the *Bardahl* formula to include credit considerations.

It is interesting to note that, though the court could find no case which had previously applied the *Bardahl* formula to finance companies, such an application was held permissible.⁴⁰⁷ While admitting that the formula had been found inapplicable to “service” companies⁴⁰⁸ and title and trust companies,⁴⁰⁹ its previous application to sales companies,⁴¹⁰ leasing companies,⁴¹¹

⁴⁰¹ *Id.* at § 532; 34 P-H TAX CT. MEM. at 1140.

⁴⁰² 34 P-H TAX CT. MEM. at 1141; 583 F.2d at 478.

⁴⁰³ *Bardahl Int’l Corp.*, 35 P-H TAX CT. MEM. ¶ 66,182 (August 5, 1966).

⁴⁰⁴ *Id.* at 1063.

⁴⁰⁵ 583 F.2d at 480.

⁴⁰⁶ *Id.*

⁴⁰⁷ *Id.* at 483.

⁴⁰⁸ *See, e.g., Myron’s Ballroom v. United States*, 382 F. Supp. 502, 588 (C.D. Cal. 1974), *rev’d and remanded on other grounds*, 548 F.2d 331 (9th Cir. 1977).

⁴⁰⁹ *See, e.g., Inter-County Title Co. v. United States*, 75-2 U.S.T.C. ¶ 9845 (E.D. Cal. 1975).

⁴¹⁰ *See, e.g., 35 P-H TAX CT. MEM.* at 1051; *Hardin v. United States*, 461 F.2d 865 (5th Cir. 1972).

⁴¹¹ *See, e.g., Cataphote Corp. of Miss. v. United States*, 535 F.2d 1225, 1234-35 (Ct. Cl. 1976).

and others swayed the court into concluding that finance companies should not be excluded, at least not as a matter of law.⁴¹²

11.03 Gift of Corporate Stock Followed by a Redemption

In Revenue Ruling 78-197,⁴¹³ the IRS ruled that a taxpayer with voting control of both a corporation and an exempt private foundation who donates shares of the corporation's stock to the foundation and through a prearranged plan causes the corporation to redeem the shares, does not realize income from the redemption. However, the Service ruled that the taxpayer-donor's proceeds from the redemption will be treated as income if the tax-exempt foundation is legally bound or can be compelled by the corporation to surrender the shares for redemption.⁴¹⁴

The facts presented in the ruling are similar to those in *Palmer v. Commissioner*.⁴¹⁵ In *Palmer*, the Palmer College of Chiropractic was a profit making Iowa corporation with 72% of the stock owned by a trust administered by the taxpayer.⁴¹⁶ The taxpayer owned the remaining shares in his own name.⁴¹⁷

The taxpayer decided that the college should be turned into a non-profit institution.⁴¹⁸ It was the taxpayer's belief that the alumni would support the school if it were evident that the taxpayer's family would not be enriched by any contributions.⁴¹⁹ In addition, any contributions would be deductible for federal income and estate tax purposes.⁴²⁰

To fulfill his goal, the taxpayer organized the Palmer College Foundation. The IRS in a private letter ruling qualified the Foundation as a tax-exempt organization under Section 501 (c) (3).⁴²¹ According to a carefully prearranged plan, the Foundation acquired all of the corporation's stock that was held in trust in exchange for a note payable in annual installments over a thirty-five year period.⁴²² The taxpayer then made a contribution to the Foundation of corporate stock sufficient so that the Foundation owned 80% of the stock of the corporation. On the next day, the board of directors of

⁴¹² 583 F.2d at 483.

⁴¹³ Rev. Rul. 78-197, 1978-1 CUM. BULL. 83.

⁴¹⁴ *Id.*

⁴¹⁵ 62 T.C. 684 (1974), *aff'd*, 523 F.2d 1308 (8th Cir. 1975). See Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 203 (1975).

⁴¹⁶ *Id.*

⁴¹⁷ *Id.* at 686.

⁴¹⁸ *Id.*

⁴¹⁹ *Id.*

⁴²⁰ *Id.* at 687.

⁴²¹ *Id.* at 689.

⁴²² *Id.*

the corporation voted to redeem the shares of stock by transferring all of the assets of the college to the Foundation.⁴²³

The Commissioner argued that the transaction constituted a redemption under Section 301⁴²⁴ taxable to the taxpayer as a dividend.⁴²⁵ Thus, the redemption proceeds after being taxed to the taxpayer as personal income would be considered a donation to the Foundation.⁴²⁶ In rejecting the Commissioner's position, the Tax Court found ample evidence that an actual gift had been made to the Foundation. Nor could the court in good conscience classify the transaction as a sham.⁴²⁷ The court recognized the fact that the taxpayer retained control over the policies of the college. However, the control of the affairs of the college are not tantamount to ownership considering that the taxpayer had no rights to the profits.⁴²⁸

Essential to the court's favorable ruling to the taxpayer was the finding that the Foundation was not bound to go through with the redemption at the time it received the shares. The Tax Court noted that the transaction would be taxable as a dividend to the donor-taxpayer if the donee is bound by the corporation to surrender the shares for redemption.

11.04 Type A Reorganization — Continuity of Interest

Under Section 368 (a)⁴²⁹ certain specifically defined transactions are exempted from the regular rules which require gain or loss to be recognized in the sale or exchange of property.⁴³⁰ In addition to the statutory requirements, one requirement that is imposed by the courts upon Type A reorganizations⁴³¹ is that the merger or consolidation must be such that the stockholders of the reorganizing corporations maintain a continuity of interest, that is, that their investment must remain in the resulting corporation.⁴³² For example, if a shareholder's stock is exchanged for any combination of bonds, cash or short term notes, the former shareholder has become a creditor and has no continuity of interest.⁴³³

⁴²³ *Id.*

⁴²⁴ INT. REV. CODE of 1954, § 301.

⁴²⁵ 62 T.C. at 690.

⁴²⁶ *Id.* at 691.

⁴²⁷ *Id.*

⁴²⁸ *Id.* at 694.

⁴²⁹ INT. REV. CODE of 1954, § 368(a).

⁴³⁰ See Treas. Reg. § 1.368-1(b).

⁴³¹ Type A reorganizations are statutory mergers and consolidations. See INT. REV. CODE of 1954, § 368(a).

⁴³² See, e.g., *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir. 1951); *Rocbling v. Commissioner*, 143 F.2d 810 (3rd Cir. 1944).

⁴³³ See, e.g., *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Commissioner v. Johnson*, 267 F.2d 382 (5th Cir. 1959).

In *First Federal Savings & Loan Association*,⁴³⁴ a non-stock savings and loan association entered into a merger agreement with a state chartered stock savings and loan association. Under the agreement, the non-stock corporation acquired the common stock and savings deposits of the stock corporation, while the stockholders were given savings deposit accounts of the non-stock corporation in return for their stock.

The IRS contended that there was no continuity of interest because the stockholders gave up "pure equity" for the savings deposit accounts, which were so liquid that they amounted to cash. The district court disagreed, finding that a savings account is the only proprietary interest one can have in a non-stock savings and loan association. The test for continuity of interest was whether there continued to be an acquired equity interest of substantially the same amount as the stockholders originally controlled. The interest received did not have to be identical to that which was surrendered. Therefore, since the savings accounts represented a definite and material equity interest in the non-stock savings and loan association, the transaction qualified as a Type A reorganization.

11.05 Section 337 Liquidation — Type C Reorganization

The Internal Revenue Service has recently approved in a letter ruling⁴³⁵ a method whereby an owner of closely held corporate stock can exchange his stock for shares in a mutual fund without incurring a tax liability. The transaction involved a Section 337 liquidation⁴³⁶ and Type C reorganization.⁴³⁷

The facts involved Corporation X which is engaged in business as a diversified open-end registration investment company, and Corporation Y, a closely held corporation. Corporation Y has outstanding 853 shares of \$100 par value common stock and thirty-six shares of 5% cumulative non-voting preferred stock. The president of Corporation Y, A, owns approximately 11% of the outstanding common stock and 14% of the preferred stock.

Prior to entering into the proposed plan of reorganization, Corporation Y intends to sell all of its assets to a newly formed corporation, Newco, in exchange solely for cash. The purchase price established for Y's assets is equal to the fair market value of the assets. The present business operations of Y will continue to be conducted by Newco, with A owning 79% of the outstanding shares of the new corporation.

After the sale of assets to Newco and pursuant to the reorganization

⁴³⁴ 78 U.S.T.C. ¶ 9398 (1978).

⁴³⁵ Letter Ruling 7825045, March 23, 1978.

⁴³⁶ INT. REV. CODE of 1954, § 337.

⁴³⁷ *Id.* at § 368(a)(1)(c).

plan, Corporation Y will transfer the cash proceeds of the sale of its assets to Corporation X solely in exchange for shares of X voting stock. The shares are to be valued by the net asset method as of the close of the New York Stock Exchange on the date of the transfer.

Upon receipt of X shares, all or substantially all of the shares will be distributed on a pro rata basis within one year to Y's shareholders in complete liquidation of their stock interest in Y. Y is to sell a small portion of the Y shares in order to raise funds for the payment of any liabilities or expenses arising after the sale to Newco. Any excess cash not needed will be distributed to former Y shareholders. The reorganization plan provided, as required by state law, that Y shareholders have dissenter rights. Y is responsible for any amounts of money payable to dissenters.

A Section 337 liquidation occurs when a corporation adopts a plan of complete liquidation in which all of its assets, except those retained to meet the claims of creditors or possible contingent liabilities are distributed within a twelve month period beginning on the date the plan is adopted. If successfully completed, a corporation adopting such a plan will not recognize a gain or a loss on the distribution of its property. A Section 337 liquidation does not apply unless there is distribution to shareholders.⁴³⁸

In the present fact situation, there is no problem with nonqualifying assets and distributions such as stock in trade, inventory or installment obligations.⁴³⁹ However, it is worth noting that Section 337 (b) (2)⁴⁴⁰ makes an exception for a bulk sale of substantially all the inventory to one person in a single transaction. Another exception is installment obligations acquired on a sale of property other than inventory or on a bulk sale of inventory after adoption of the plan of liquidation. These obligations can be sold or exchanged by the corporation under Section 337 (a), or distributed without recognition of gain or loss under Sections 336⁴⁴¹ and 453 (d) (4) (B).⁴⁴²

Under Section 354 (a) (1),⁴⁴³ no taxable income is received and no deductible loss is sustained by a shareholder upon an exchange of stock and/or securities if the following four conditions are fulfilled: 1) there is a reorganization as defined in the Internal Revenue Code; 2) the exchange is effected pursuant to the plan of reorganization; 3) only stock or securities or both are taken and given; 4) the stock or securities exchanged are issued by a corporation which is a party to the reorganization. Under Section 368

⁴³⁸ *Id.* at § 337(a); Rev. Rul. 56-387, 1956-2 CUM. BULL. 189.

⁴³⁹ INT. REV. CODE OF 1954, §§ 337(b)(1) - (3).

⁴⁴⁰ *Id.* at § 337(b)(2).

⁴⁴¹ *Id.* at § 336.

⁴⁴² *Id.* at § 453(d)(4)(B).

⁴⁴³ *Id.* at § 354(a)(1).

(a) (1) (c),⁴⁴⁴ a Type C Reorganization involves one corporation acquiring substantially all of the assets of another corporation solely in exchange for its own voting stock or the voting stock of its parent corporation. A Type C Reorganization is similar to a statutory merger but has the advantage of not requiring strict compliance with state merger laws.⁴⁴⁵ The Service has utilized a percentage of the assets test stating that for ruling purposes the "substantially all" requirements of Section 368 (a) (1) (c) is satisfied when a transfer of assets represents at least 90% of the fair market value of net assets and a minimum of 70% of the fair market value of gross assets held by the acquired corporation immediately preceding the transfer.⁴⁴⁶ The test should be applied after the reduction of gross assets by liabilities.⁴⁴⁷

Upon the facts submitted, the Service ruled that the transaction would qualify as a reorganization within the meaning of Section 368 (a) (1) (c). In addition, no gain or loss would be recognized to Y on the transfer of its assets to X in exchange for X common stock. No gain or loss would be recognized to the shareholders of Y upon the exchange of their shares of stock in Y for shares of X common stock. As a result of the liquidation and reorganization, A was able to exchange his stock in Y for shares in X without incurring any tax liability.

12.00 Subchapter S Corporations

12.01 Capital Gains — Section 337 Liquidation

Under Section 1373 (a)⁴⁴⁸ undistributed taxable income of an electing small business corporation will be included in the gross income of the shareholders in the manner set forth in Section 1373 (b).⁴⁴⁹ However, pursuant to Section 1378,⁴⁵⁰ if for a taxable year of an electing small business corporation the net capital gain of such corporation exceeds \$25,000 and exceeds 50% of its taxable income for such year, and the taxable income of the corporation for the year exceeds \$25,000, there is imposed a tax on the income of the corporation. The rationale of Section 1378 is to prevent a "pass-through" of a large amount of capital gains to the shareholders by avoiding the capital gains tax at the corporate level.

⁴⁴⁴ *Id.* at § 368(a)(1)(c).

⁴⁴⁵ FED. TAX COORD. 2d ¶ 22,315 (1978).

⁴⁴⁶ REV. PROC. 66-3, 1966-2 CUM. BULL. 272.

⁴⁴⁷ REV. PROC. 74-26, 1974-2 CUM. BULL. 478.

⁴⁴⁸ INT. REV. CODE OF 1954, § 1373(a).

⁴⁴⁹ INT. REV. CODE OF 1954, § 1373(b). The Code requires each person who is a shareholder of an electing small business corporation on the last day of the taxable year of the corporation to include in gross income, for the taxable year in which or with which the taxable year of the corporation ends, the amount the shareholder would have received as a dividend, if on the last day there had been distributed pro rata to its shareholders by the corporation, an amount equal to the corporation's income for the taxable year.

⁴⁵⁰ INT. REV. CODE OF 1954, § 1378.

The IRS has recently held in Revenue Ruling 78-89⁴⁵¹ that a Subchapter S corporation may realize a capital gain in excess of \$25,000 and distribute it to its shareholders without a Section 1378 penalty if the distribution was part of a complete liquidation.⁴⁵² Therefore, the corporation would not have a taxable capital gain, and the shareholders would be subject to capital gain tax only to the extent that the amounts distributed to them in liquidation exceeded their adjusted basis.

⁴⁵¹ Rev. Ruling 78-89, 1978-1 CUM. BULL. 272.

⁴⁵² A complete liquidation requires distribution of all assets to the shareholders within twelve months of the adoption of the plan. See INT. REV. CODE of 1954, § 337.