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Federal Income Tax Developments: 1975

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FEDERAL INCOME TAX DEVELOPMENTS: 1975

MERLIN G. BRINER*

INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1975 is the third of an annual series of articles to be published in the Winter Issue of the AKRON LAW REVIEW. The thrust of this article is not only to identify the new developments, but also to trace these concepts through their formative stages. The area of concentration for this article includes cases decided through September 30, 1975. 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 tax year. The purpose of this article is to highlight for the practitioner the key alterations which have transpired over the tax year.

A synopsis of the Tax Reduction Act of 1975 precedes the TABLE OF CONTENTS. The Act contains key amendments in the area of income tax, which will affect individual and corporate taxpayers alike. Also of special note are the significant and numerous developments which have occurred in the area of *deductions*. A TABLE OF CASES, TABLE OF INTERNAL REVENUE CODE SECTIONS and a TABLE OF RECENT REVENUE RULINGS can be found following the text of the article.

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: Kevin C. Krull, Frank B. Mazzone, Leonidas E. Plakas, Lawrence H. Richards, and William C. Wilkinson. Special recognition is extended to Timothy A. Shimko for his fine efforts.

*B.B.A., Wichita State University; J.D., University of Akron, School of Law; Associate Professor of Law, University of Akron; formerly manager, Tax Department, The Timken Co., Canton, Ohio.

SUMMARY OF THE TAX REDUCTION ACT OF 1975

On March 29, 1975, President Ford signed into law Pub. L. No. 94-12, the Tax Reduction Act of 1975, which has been labeled as the largest tax-cut measure in the history of the United States. It is anticipated that this Act will result in net individual and corporate tax reductions approaching \$22.8 billion. Presented below is a brief synopsis intended to familiarize the reader with the key changes provided by the recent tax measure.

BASIC CORPORATION TAX

The Act changes the rate for corporate taxes to 20% on the first \$25,000 of taxable income, and to 22% on the next \$25,000 of taxable income. The rate for taxable income in excess of \$50,000 remains at 48%. This results in a savings of \$7,000 for those corporations with taxable income of \$50,000 or more. For fiscal-year corporations the amount of the savings must be computed on the basis of a proration of days in 1975.

The minimum accumulated earnings credit has been increased from \$50,000 to \$150,000 for taxable years beginning after December 31, 1974.

INVESTMENT CREDIT

The Act changes the investment credit rate from 7% (4% rate for utility property) to 10% for tangible personal property which is bought and placed in service after January 21, 1975 and before January 1, 1977. If the property is constructed by the taxpayer and completed and placed in service after January 21, 1975, it qualifies for the investment credit even though not completed and placed in service until January 1, 1977. However, if the property is not placed in service until January 1, 1977, then only that portion of the property constructed between January 21, 1975 and January 1, 1977 qualifies for the investment credit.

The Act increases the dollar limitation on used property qualifying for the credit from \$50,000 to \$100,000 per year for taxable years beginning after December 31, 1974 and before January 1, 1977.

An additional 1% investment tax credit is allowed if the corporation transfers employer securities into an Employee Stock Ownership Plan (ESOP). In order to qualify, the securities must have a value of at least the amount of the increase in the investment credit. This provision of the Act applies to transfers between January 21, 1975 and January 1, 1977.

INDIVIDUAL TAX

The Act increases the low income allowance and the standard deduction for the 1975 tax year. The minimum standard deduction (low income allow-

ance) is \$1,900 for married persons filing joint returns and surviving spouse, \$1,600 for single taxpayers, and \$950 for married persons filing separate returns. The standard deduction has been increased to 16% with a maximum of \$2,600 for married persons filing joint returns and surviving spouse, \$2,300 for single taxpayers, and \$1,300 for married taxpayers filing separate returns. No tax return need be filed if gross income is less than \$3,400 for a married couple; \$2,650 for a surviving spouse; \$2,350 for a single taxpayer; and \$1,700 for a married taxpayer filing a separate return.

The taxpayer is permitted a credit of 5% or \$2,000, whichever is the lesser of the purchase price of a new home, condominium, or mobile home, providing the home is the taxpayer's principal residence. The original use of the home must commence with the taxpayer. Construction on the home must have started before March 26, 1975, and the home must be purchased between March 13, 1975, and December 31, 1976. The seller of the home must provide the buyer with a certification that the purchase price is the lowest at which the residence was offered for sale after February 28, 1975. This certificate must then be attached to the buyer's income tax return. The credit is limited to one residence per taxpayer.

The Act extends the replacement period on the sale of a taxpayer's principal residence to 18 months for the purchase of a new home and 24 months for the construction of a new home.

The child and dependent care deduction income limitation has been increased from \$18,000 to \$35,000. Since the deduction is reduced by one dollar for every two dollars of adjusted gross income over \$35,000, a taxpayer with an adjusted gross income of \$44,600 is ineligible for this deduction.

Additionally, a credit of \$30 is extended to each taxpayer for each exemption—except old age and blindness—claimed for the taxpayer, his spouse and his dependents. The personal exemption credit is available on 1975 calendar year and 1975-76 fiscal year returns.

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1.00 Income

1.01 Assignment of Income

It has long been recognized that a taxpayer may not reduce his income tax burden by assigning income to others. Applying this principal, the Commissioner in *S. C. Johnson & Son, Inc.*,¹ assessed the Johnson Corporation with a deficiency for not including in gross income the gain made from a disposition of a forward sales currency contract which the taxpayer had given to a tax exempt organization as a charitable contribution.

In the summer of 1967, *S. C. Johnson & Son, Inc.*, a multinational corporation, attempted to hedge against the possible devaluation of the British pound. It made two £750,000 forward sales contracts with two New York banks whereby the banks were obligated to pay Johnson \$2,765 per pound, to be delivered by Johnson within one year. The pound was in fact devalued to \$2.40 and Johnson was in a position to realize substantial profit. Instead of taking this profit and increasing its tax liability, Johnson donated the contracts to a charitable foundation. The foundation negotiated an agreement, whereby it sold its contract rights to a third party; thus receiving the sizeable profit that the taxpayer might have realized itself.

Finding that there was a "reasonable probability" that the profit could be realized,² the Commissioner asserted that this was a classic assignment of income situation. However, the Tax Court disagreed, pointing out that Johnson & Sons, Inc., had no right to the profit, until it was able to deliver the British pounds. Even though the *Johnson* court recognized that this would be relatively easy to accomplish, it declared that there was the possibility that unexpected market fluctuations would wipe out the taxpayer's paper profit. Additionally, the court gave weight to the fact that no negotiations were commenced and no agreement reached regarding closing out the corporation's forward position until after the contracts had been given to the charitable foundation. The result in *Johnson* seems appropriate when the donation of the appreciated forward sales contracts is analogized to a charitable contribution of appreciated stocks or bonds.³ Although there is also a "reasonable probability" that the profit will be realized with appreciated stock, it is basic that a charitable contribution of appreciated stock does not result in income to the transferor. Indeed, the *Johnson* court recognized this analogy in striking down the Commissioner's easy conversion argument.⁴

¹ 63 T. C. No. 74 (March 31, 1975).

² *Id.*

³ INT. REV. CODE OF 1954, § 170 (b).

⁴ 63 T. C. at 438.

1.02 Net Gift Tax Liability

*Edna Bennett Hirst*⁵ is the most recent case which attempted to resolve the issue of net gift tax liability. The petitioner owned a one-half interest in three tracts of undeveloped land with an adjusted basis of \$8,377.00 and an appraised value of \$444,588.50 with the remaining one-half interest in her husband's estate. Petitioner's liquid assets consisted of \$25,000.00 in a savings account. The ownership of the land was a burden for petitioner, since it did not produce any income and subjected her to liability for the property taxes. Due to her limited liquid assets and for the benefit of her son and his family, the petitioner in 1967 transferred three tracts of land to her son and his family through inter-vivos gifts and a trust, upon the condition that the recipients pay all resulting gift taxes. In 1968 her son and his wife paid all gift taxes. In petitioner's 1968 tax return, she failed to include the transfer of the property whereupon the Commissioner found a taxable recognized gain of \$38,546.28 derived from the benefit petitioner received from her son's payment of the gift tax.

Whether a donor derives taxable income benefits when she makes a gift of appreciated property to another, conditioned on the donee paying all resulting gift taxes, is a question which has repeatedly caused considerable confusion.

Section 2502(d) of the 1954 Internal Revenue Code provides that the burden of paying the gift tax is the donor's responsibility, but if the donee agrees to pay the tax and absorbs the liability, the donor's obligation is absolved.⁶ Ordinarily the donor is viewed as having received a benefit which may be taken into account when determining taxable income.⁷

The most common legal devices used to initiate and complete the transfer of property for tax advantages are revocable trusts, irrevocable trusts, testamentary trusts, and inter-vivos gifts. The structure of the vehicle implemented and the true purpose for its creation and use in the transfer of the property are essential in determining the validity of the donor's argument that he received no taxable benefits.

The early development of case law in this area centered upon the use of trusts. In the 1942 case of *Estate of A. E. Staley, Sr.*,⁸ the donor desired to give to his five children \$2,000,000.00 worth of stock, but lacked funds to pay the resulting gift tax. In order to satisfy his objective of transferring the stock, he required the trustee to pay him \$150,000 from the trust income

⁵ 63 T. C. No. 27 (Dec. 9, 1974).

⁶ *Id.* at 315.

⁷ *Douglas v. Willcuts*, 296 U.S. 1 (1935).

⁸ 47 B.T.A. 260 (1942), *aff'd*, 136 F.2d 368 (5th Cir), *cert. denied*, 320 U.S. 786 (1943).

which equaled the amount of the gift tax. The court in rejecting the petitioner's contention that the transfers were part-sale, part-gift, held that the income from the trusts was taxable as income. The income was reserved for the benefit of the donor; therefore, it was taxable to his income.

A later case, *Estate of Craig R. Scheaffer*,⁹ affirmed this view, adding that where the gift tax was paid out of the income of the trust by the trustees, the donor was found to have received a taxable income benefit. The Eighth Circuit in affirming the decision stated: "What the trustee received as trust income and applied to payment of the gift tax, the Scheaffers in reality constructively received, and on that the petitioners must be taxed."¹⁰

*Estate of Annette S. Morgan*¹¹ marked a shift in the Tax Court's position. In this case, the petitioner in 1955 created irrevocable trusts in favor of her issue consisting of 41,600 shares of Morgan Engineering Company stock with an approximate value of \$1,000,000.00 at time of transfer. Her son and her attorney were co-trustees of the trusts. A clause in the trust agreement stated in part, as follows:

. . . the stock is transferred subject to the trustee's obligation to pay all such taxes. The trustees shall make all necessary arrangements for and attend to the payment of all said taxes, and may raise funds for such purposes by selling a portion of the transferred stock and/or by borrowing, the decision to sell stock and/or borrow to be made in accordance with the sole discretion of the trustees.¹²

In 1956 the trustees arranged for a bank loan in the exact amount of the gift tax, pledging the Morgan Stock as security. They subsequently paid the loan with trust income in subsequent years. The respondent contended that the trust incomes from the years 1957 and 1958 used to pay the loan were taxable to the settlor. The Tax Court held that the petitioner received no taxable benefits in 1957 and 1958 from the trust income stating: "Therefore, since the decedent received no benefit from the fact that the trustees borrowed to discharge her tax obligation and repaid the loan from trust income, she cannot be held to have constructively received the income used to repay the loan."¹³ From the record, no mention is made of charging the donor with income in the earlier years, when on the alternative theory, the gift tax liability was discharged.¹⁴

⁹ 37 T. C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963).

¹⁰ 313 F.2d 738 at 743 (8th Cir. 1963).

¹¹ 37 T. C. 981 (1962), *aff'd*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963).

¹² *Id.* at 982, *aff'd*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963).

¹³ *Id.* at 985.

¹⁴ 63 T. C. No. 27 (Dec. 9, 1974).

In deciding *Hirst*, the court placed great significance on *Turner v. Commissioner*.¹⁵ The facts in *Turner*, as stipulated, were that the donor made nine separate gifts of appreciated stock, three through inter-vivos gifts and six through trusts. The gifts were subject to the condition that each individual receiving a gift was to pay his share of any and all resulting gift taxes as determined by donor's tax counsel. The Commissioner argued that the three inter-vivos gifts were part-gift, part-sale transfers. The Court upheld the well-established rule that "it is the substance rather than the form of the transfers which must be the decisive factor."¹⁶ The substance test utilized in *Turner* was directly applicable to the fact situation in *Hirst*. The intention of the Tax Court in both *Turner* and *Hirst* was to impose the gift tax only upon the "net gift" made by the donor, that is the gross amount of the property transferred, less the value of the gift tax payable on the transfers.

With respect to the question of whether the trust transaction in *Hirst* should be considered as part-gift, part-sale, *Krause v. Commissioner*¹⁷ refused to accept a transfer of securities through trusts as part-gift, part-sale. The court, relying upon *Turner* as the controlling authority, found no capital gain once the donor's gift tax obligation had been fulfilled.

The donor created three trusts for transfer of property conditioned upon the trustees paying all resulting gift taxes. The court held that when the donor has substantial dominion and control over the trust income, prior to the payment of the gift taxes, that income is taxable to the donor. However, once the trustees had paid the gift taxes, the donor's liability as to taxable income ceased to exist. For tax purposes the donor was viewed under Internal Revenue Code Sections 671 and 677 as being the owner of the trust property until his obligation to pay the gift tax was satisfied.¹⁸ Therefore, only the income from the trust property, which was earned before the gift tax was satisfied, was chargeable to the donor's taxable income. The current holding conforms with the *Morgan* court's determination as to when income tax liability has ended.

The preceding cases demonstrate substantial support for the decision in *Hirst* favoring the taxpayer's position, but in *Johnson v. Commissioner*,¹⁹ the requirements by which the donor could escape tax consequences on net gifts were tightened. In *Johnson*, the petitioner owned and used securities, having a basis of \$10,812.50 and a market value of \$500,000.00, as collat-

¹⁵ 410 F.2d 752 (6th Cir. 1969), *aff'd per curiam*, 49 T. C. 356 (1968).

¹⁶ 49 T. C. 356 at 363 (1968).

¹⁷ 56 T. C. 1242 (1971).

¹⁸ *Id.* at 1245.

¹⁹ 495 F.2d 1079 (6th Cir. 1974), *aff'd* 59 T. C. 791 (1973).

eral to obtain a \$200,000.00 thirty day note. Upon receiving the loan, the petitioner established an irrevocable trust for his children, transferring his ownership in the securities to the trust. The trustee assumed the loan obligation by substituting his note for the donor's note and placing the newly transferred securities of the trust as collateral. The petitioner paid \$147,072.51 in gift tax, thereby netting \$52,927.49 from the loan transaction. The respondent, implementing the part-gift, part-sale rationale of *Crane v. Commissioner*,²⁰ contended that petitioner had a long-term capital gain of the amount of the loan (\$200,000.00) less the basis of the transferred stock (\$10,812.50). Petitioner argued that under *Turner* the \$147,072.51 paid gift tax should be deducted from the amount taxed as capital gain. But the Tax Court in *Johnson* distinguished the *Turner* case, holding that:

The instant case is distinguishable from the *Turner* case both on the facts and the issues presented. The transfers in the present case were not conditioned on the payment of the gift tax liabilities by the recipients and no issue involving the payment of gift taxes is presented herein. Nor was there any reservation or retention by the donor in the present case, of any right or interest in the corpus or income of the trusts such as was found by the Court in the *Turner* case. Nor, in our opinion, are the loans in the present case to be equated with the gift tax liabilities in the *Turner* case.²¹

The Sixth Circuit Court of Appeals, in affirming the Tax Court, applied the substance test and concluded that whether the transaction is described as "part-sale and part-gift" or a "net gift" has no importance."²² Each taxpayer received value upon transferring his encumbered stock into trust; therefore, tax liability should have attached at the moment of transfer. In the court's opinion there was "no basis whatsoever in the provisions of the Code for taxpayers' assertion that a donee's discharge of a donor's gift tax liability does not constitute the realization of income"²³ The court reasoned:

We find it immaterial whether the transaction is found to be "part-sale and part-gift." This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash. The effect of imposing a capital gain tax at the time of the stock's transfer is to collect the tax at that time,

²⁰ 331 U.S. 1 (1947).

²¹ 59 T. C. 791, at 812-13.

²² 495 F.2d at 1083.

²³ *Id.* at 1084.

rather than to defer the tax until the trustees dispose of it through a taxable event.²⁴

The *Hirst* court acknowledged that the Sixth Circuit in affirming *Johnson Jr.* had strongly criticized the *Turner* decision; nevertheless, the Sixth Circuit had previously affirmed *Turner* and did not overrule that decision in affirming *Johnson Jr.* The *Hirst* court also recognized the more "realistic" approach suggested in *Johnson Jr.*, but it refused to discard a position which has been steadily developing through a number of cases over an extensive period of time. In light of the previous pattern of decisions in this area, the *Hirst* court refused to extend *Johnson Jr.* to *Hirst* without *Turner* first being directly overruled by the Sixth Circuit.

In summary, the donor's tax liability as to appreciated transferred property has not been clarified by the recent Tax Court and Sixth Circuit Court decisions. The courts are, however, placing an increasing reliance upon the substance test.

1.03 Determination — Gift or Income

Whether monies or "tokens" which were received by a craps dealer in Las Vegas from patrons of the casinos where he worked are taxable as income, under Section 61 of the Internal Revenue Code, or as gifts under Section 102(a), was recently decided in *Olk v. United States*.²⁵ In *Olk*, petitioner was employed as a craps dealer in two gambling casinos. While on duty, patrons occasionally gave "tokens" to the petitioner for good luck or for other superstitious reasons. At the end of each shift all employees working a table would equally divide the "tokens" among themselves under the policy of the employer. The petitioner contended that the "tokens" were gifts under Section 102(a) of the 1954 Code and were therefore excluded from his income. The Commissioner characterized the "tokens" as tips and, as such, were to be included taxable income.

The District Court decided the controversy in favor of the taxpayer holding the "tokens" to be gifts. The court based its decision upon the uniqueness of the petitioner's position. The taxpayer does not furnish a personal service, but merely carries out the duties of his employment. Contrast this to a taxicab driver or waiter who performs personal services in order to obtain tips.²⁶ The taxicab driver or waiter can give special service to customers in order to receive larger tips. However, if the petitioner demonstrated the slightest inclination to give special service to a patron, he would be immediately dismissed from his employment.

²⁴ *Id.*

²⁵ 388 F. Supp. 1108 (D. Nev. 1975).

²⁶ *Andrews v. United States*, 295 F.2d 819 (Ct. Cl. 1961), cert. denied, 369 U.S. 289 (1962).

The court held that the determinative factor in determining a gift is the intent with which the payment is made.²⁷ Patrons gave “tokens” on sudden impulses of generosity in order to share their good luck with others, including other patrons and spectators and not as compensation for services rendered. There is no obligation or social compulsion for a patron to give anything to a dealer (90% to 95% of gambling patrons give nothing to dealers).

The situation of the craps dealer is easily distinguishable from that of taxicab drivers or waiters who receive tips as a result of the custom or moral compulsion of their customers, even though the performed service may be less than desirable. In the case of the taxicab driver or the waiter, tips are not given out of a feeling of “affection, respect or admiration” but instead they have become “expected”²⁸—a form of compensation for services rendered. Since “tokens” received by a craps dealer are not tips, but gifts under the meaning of Section 102(a), they are excluded from gross income.

1.04 Deferred Compensation

In *Gale R. Richardson*²⁹ the petitioner, a doctor, entered into an agreement in 1969 with the hospital in which he was employed. Each month the hospital was to put \$1,000 of earned income into a nonexempt trust for which a local bank acted as trustee. The trust agreement contained several provisions: First, the trust was to be held for the benefit of any person, corporation, or trust designated by Dr. Richardson, and in absence of a designation, Dr. Richardson would be the beneficiary of the trust upon his death, retirement, or separation of service from the hospital; second, the trust required petitioner to perform part-time services as may be required by the hospital during his lifetime and after termination of his employment. For such service, the doctor would be paid at the same rate he was being paid when he left the employment of the hospital. He would also be reimbursed for expenses incurred in performing the service. An amended trust agreement, dated April 2, 1970, provided that if petitioner failed to render such service without good cause, he would forfeit all rights under the trust agreement.

Dr. Richardson did not report any of the trust money for 1969 and 1970. The Tax Court found that the petitioner received an economic benefit from the hospital's payment of his compensation into the trust.³⁰ The court therefore concluded that the compensation was currently taxable unless Section 402(b) of the Internal Revenue Code deferred tax consequences. Since Section 402(b) was amended by Section 321(b)(1) of the Tax Reform Act

²⁷ *Comm'r v. Duberstein*, 363 U.S. 278 (1960).

²⁸ *Andrews v. United States*, 295 F.2d 819 (Ct. Cl. 1961).

²⁹ 64 T. C. No. 63 (July 23, 1975).

³⁰ See *E. T. Sproull*, 16 T. C. 244, 247-48 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

of 1969,³¹ the tax consequences must be evaluated in light of two time periods, *i.e.*, prior to August 1, 1969 and after August 1, 1969.

For the time period prior to August 1, 1969, Section 402(b) provided that contributions to an employee's trust were includable in an employee's gross income "for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made." The Regulations define "nonforfeitable" as "no contingency under the plan which may cause the employee to lose his rights in the contribution."³²

After August 1, 1969, Section 402(b) provided that contributions to an employee's nonexempt trust will be included in gross income of an employee in compliance with Section 83(a), which states that such income will be included in gross income when the income is "not subject to a substantial risk of forfeiture."³³ Section 83(c) (1), by example, points out that if a person's right to enjoyment of property is conditioned upon the future performance of substantial services by any individual, such condition may constitute a substantial risk of forfeiture. The Tax Court held that petitioner's trust agreement failed to meet either version of Section 402(b); therefore, it was not within the meaning of Section 83(c) (1) of the Code. The court found that the money paid into the trust was actually earned compensation otherwise receivable by petitioner. Furthermore, he had not shown any reason for subjecting the money to forfeiture. The trust deposits were paid out for past and current services and not future services; they, therefore, represented compensation. The provisions of the trust agreement also authorized 50 percent of the entrusted funds to be invested in an insurance contract on the doctor's life and the other 50 percent to be invested in mutual fund shares which were not subject to forfeiture. Therefore, their cost was current income taxable to the petitioner.³⁴

The trust provision relating to optional transfers eliminated any risk of forfeiture of the corpus, since a transfer to the petitioner could be accomplished by two methods. First, the trustee could transfer by absolute assignment to the doctor or, if petitioner were dead, to his beneficiary. Second, the trustee could transfer, by absolute assignment of the corpus, to another person or corporation who has employed the petitioner. Such possibility of transfer would abolish the risk of forfeiture for failure to perform post retirement services.

³¹ Tax Reform Act of 1969, Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487.

³² Treas. Reg. § 1.402(b)-1(a)(2)(i).

³³ Estate of James Max Harrison, 62 T. C. 524, 530-32 (1974).

³⁴ Paul L. Frost, 52 T. C. 89, 95-96 (1969).

In order to take advantage of Section 83(c)(1), the court held that the employee would have to be expected to perform substantial services in the future.⁸⁵ The petitioner had not shown that the hospital had any need or expected to have any need for such services. In fact, it was stipulated that the hospital had not received advice and counsel services from retired physicians during the years of 1969 and 1970 or at any previous time.

The use of a nonexempt trust to defer income will not be permitted unless the taxpayer is subject to a substantial risk of forfeiture of his interests in the trust. The substance rather than the form of the transaction will be the controlling factor in the determination of the tax liability.

1.05 Property Settlements

Under what circumstances a person realizes a taxable gain or loss on the transfer of stock to his former wife, in compliance with an agreement incorporated into a divorce decree, was decided in *Worthy W. McKinney*.⁸⁶ The petitioner in *McKinney* transferred personal property, cash, insurance policies and appreciated stock to his wife pursuant to a property settlement accompanying a divorce decree. Petitioner failed to report on his tax return a gain on the transfer of the appreciated stock. The Commissioner argued that petitioner realized a long-term capital gain on the transfer of stock. Petitioner contended that the transfer was voluntary and without consideration, and in the alternative raised the issue that the Commissioner erroneously computed the gain by failing to take into consideration the value of all the property transferred by both parties, in accordance with the property settlement and divorce decree.

The Tax Court held that the transfer of stock was a taxable event, but that the Commissioner erred in taxing the gain on the shares of appreciated stock, without taking into consideration all of the transfers and payments made by the petitioner as indicated in the property settlement agreement and divorce decree. The court, citing *United States v. Davis*,⁸⁷ reasoned that petitioner had taxable gain on the transfer of appreciated stock in exchange for the release of his wife's marital rights. The court also ordered the petitioner and the Service to agree on the net tax result of the marital transfers or move for further action.

If losses are to be allowed to offset gains in a property settlement agreement,

⁸⁵ 64 T. C. at 350, where the court concluded:

Since there is no showing of any real likelihood that the doctor ever will be called upon to perform services, we do not think petitioner has shown that his rights under the trust are actually "conditioned upon the future performance of substantial services within the meaning of Section 83(c)(1).

⁸⁶ 64 T. C. No. 25 (July 10, 1975).

⁸⁷ 370 U.S. 65 (1962).

pursuant to a divorce decree, other problems become apparent. First, Section 267(b) of the Code disallows losses between members of a family.³⁸ Since the time of agreement is before the completion of the divorce the parties to the agreement are still married. Secondly, Section 262 provides for the disallowance of deductions for personal, living or family expenses. The contract for the disposition of the stock would be the marital settlement which is a personal transaction rather than a business or investment transaction. Therefore, one should not place strong reliance upon the results in the instant case, since it is highly improbable that the Service will agree to any loss offsets to the taxable gain on the transfer of appreciated property.

2.00 Exclusions from Income

2.01 Sick Pay

Section 105(d) of the Internal Revenue Code provides that employees who are absent from work, due to sickness or personal injuries, may exclude, from gross income, amounts received in lieu of wages, not to exceed \$100 per week. To qualify for the exclusion the sick pay must be derived from an accident or health insurance plan paid for by the employer or attributable to contributions by him to plans not includable in the employee's gross income. The Commissioner's traditional position that an employee's excludable sick pay income ended when he reached the minimum retirement age³⁹ has been changed by the final regulations of Treasury Decision 7325.⁴⁰ This decision permits an employee, forced to retire because of a disability, to exclude amounts paid through a wage continuation plan until such time as he reaches mandatory retirement age. The reversal by the Service is reflective of the trend of court decisions in recent years which hold that the taxpayer is entitled to the exclusion until he reached the mandatory age of retirement.⁴¹

Under Income Tax Regulation Section 1.105-6(a)(4) as set forth in the Treasury decision, a disabled employee who retired voluntarily instead of under disability provision (due to an apparent lack of a tax advantage in the latter) can still qualify for the new exclusion retroactively by establishing that he could have retired under a disability. This procedure also applies for establishing an exclusion in the future. The employee may continue to claim the allowable sick pay exclusion until he reaches his annuity starting date, which is generally the mandatory retirement age.⁴²

³⁸ INT. REV. CODE OF 1954, § 267(c)(4), defines family as follows: "The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants . . ."

³⁹ See Briner, *Federal Income Tax Developments*: 1973, 7 AKRON L. REV. 188, 207 (1974).

⁴⁰ T. D. 7352, 1975 INT. REV. BULL. No. 19, at 7.

⁴¹ See Brooks v. United States, 473 F.2d 829 (6th Cir. 1973); Reardon v. United States, 32 Am. Fed. Tax R. 2d 73-5199 (D.C. Colo. 1973); Jovick v. United States, 32 Am. Fed. Tax R. 2d 73-5196 (Ct. Cl. 1973); Walsh v. United States, 322 F. Supp. 613 (E. D. N.Y. 1970).

⁴² T. I. R. 1363, 9 CCH 1976 STAND. FED. TAX REP. ¶ 6527.

To redesignate the pension, the disabled retiree must file IRS Form 5401 which will soon be issued. The form will require both the employer and employee to detail information which will certify that the retiree is eligible for the disability pension. Finally, to qualify for retroactive application, IRS Form 5401 will have to be filed no later than April 15, 1977.

Revenue Procedure 73-19⁴³ set forth the conditions whereby a taxpayer was authorized to use his Form W-2 to substantiate his claim for a sick pay exclusion from income, when the Form W-2 showed the excludable amount of sick pay separately. IRS audits found that this practice resulted in erroneous exclusions of income, as employers entered incorrect amounts in the excludable sick pay section of Form W-2. Revenue Procedure 75-7⁴⁴ eliminates a period of reliance on employer calculation of excludable sick pay. The new procedure provides that the employer may list sick pay separately on the W-2, but must still include that amount in total wages. In either event, the taxpayer-employee must submit a statement with his return, indicating his computation of the excludable amount, along with information substantiating the exclusion.

2.02 Group Term Life Insurance

Section 79 of the Code permits an employee, in certain cases, to exclude from gross income the cost of up to \$50,000.00 for group-term life insurance purchased by his employer. Revenue Ruling 75-91⁴⁵ was issued to answer the question of whether or not a group insurance policy, paid for by the employer, which provides for employees in the form of level premium⁴⁶ five-year term insurance, but does not provide any other benefits such as paid-up value, cash surrender value, or an equivalent benefit, is excludable from income under Section 79.

The Service took this opportunity to clarify Revenue Ruling 71-360,⁴⁷ which states that a premium is not properly allocable to group life insurance if it is a level premium. The Service now holds that if a level premium group policy only provides life insurance protection, not exceeding a five-year term, it is not viewed as a policy of permanent insurance, provided that the individual employee's coverage under the policy ceases when the employee no longer is included in the employer's group insurance plan.

⁴³ 1973-1 CUM. BULL. 470.

⁴⁴ 1975 INT. REV. BULL. No. 5, at 28.

⁴⁵ Rev. Rul. 75-91, 1975 INT. REV. BULL. No. 12, at 8.

⁴⁶ Insurance which seeks to build up a reserve which will equal face value of policy at the end of insured's life. *Helmer v. Equitable Reserve Ass'n.*, 214 Wis. 270, 272-73, 252 N.W. 728, 729 (1934).

⁴⁷ Rev. Rul. 71-360, 1971-2 CUM. BULL. 87.

Since the employee receives no benefit other than general death benefits, the premium is properly allocable to group-life insurance, as defined under Section 1.79-1(b)(1)(i) of the Income Tax Regulations, even though it is a level premium group policy.

2.03 Foreign Income

Section 911(a) of the Code disallows, as a deduction from gross income, any deduction allocable to or chargeable against the amount excluded as income earned abroad under that section. The Service has clarified the effect of the section⁴⁸ as it pertains to sole proprietors and partners: (1) receiving service fees in excess of the maximum exclusion, (2) receiving income from services and capital in excess of the maximum exclusion, and (3) incurring expenses in excess of income.

When service fees exceed the maximum exclusion, the amount of the disallowed deduction will be the same proportion of all deductions as the exclusion is to the total earned income.⁴⁹ When the taxpayer is engaged in a trade or business in which both personal services and capital are material income producing factors, the taxpayer can claim as a reasonable allowance for compensation of personal services no more than 30% of his share of the net profits of the business. This figure sets the maximum limitation on the amount of the gross income that can be considered as earned income. Once the earned income exclusion has been determined, the disallowed deduction is in the same proportion of the total deduction as the exempt income to the total income.⁵⁰ If the expenses exceed the gross income (gross receipts less cost of goods sold) then the 30% limitation on the amount to be treated as personal service is not applicable since this limitation only applies in situations where there are net profits. The reasonable allowance as compensation for personal services rendered by the taxpayer will be the excess of the expenses over the gross income. After the exclusion has been calculated, the disallowed deduction is in the same proportion as the excluded income is to the gross income.⁵¹

In *Ivor Cornman*,⁵² the petitioner was a self-employed biological researcher living with his wife in Jamaica. During the taxable year 1970, the petitioner from his research activities had no income but did have expenses of \$7,500, of which \$7,000 was salary paid to his wife for secretarial and lab technician services. The wife's salary was not taxable since it qualified

⁴⁸ Rev. Rul. 75-86, 1975 INT. REV. BULL. No. 11, at 13.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² 63 T. C. No. 63 (March 19, 1975).

for the earned income abroad exclusion under Section 911. The taxpayer took the \$7,500 loss from his research business against his United States source income on his 1970 return. The Service argued that since Section 911(a) disallows as a deduction from gross income any deduction allocable to amounts excluded from gross income under that section, no matter how small the income, it would not be logical to allow the deduction just because the taxpayer earned no income. In other words, the expenses should not be allocable to the income but to the "attempt" to earn income. The petitioner argued that Section 911(a) requires both the presence of excluded income and deductions allocable to such excluded income; neither of which was present here since the "earned income" excluded by the petitioner's wife in 1970 was in no way attributable to the petitioner. The court looked to the legislative history of Section 911(a) and concluded that it was intended only to cover the circumstances in which there was a double tax benefit of both excluding income earned and then allowing expenses incurred in earning that excluded income.⁵³ Since there was no earned income to which the expenses could be allocable, there was no possibility of a double tax benefit and the court permitted the deductions.

However, as illustrated in *Frieda Hempel*,⁵⁴ it is clear that if the taxpayer had any earned income, none of his expenses would have been deductible. There, the taxpayer, had "earned income" of \$16.20 which was excludable as foreign source income under Section 116(a) of the Revenue Act of 1938. The court disallowed her expenses of \$5,530 since they were allocable to the excluded income.⁵⁵

3.00 Exemptions

4.00 Deductions

4.01 Moving Expenses

Section 217 of the Internal Revenue Code allows a deduction for a job related moving expense subject to certain limits. However, when a person employed by a domestic employer is transferred to a foreign country to work for the same employer, a portion, if not all, of the deduction is lost.⁵⁶ This is due to the fact that the moving expense reimbursement is includable in gross income and available for the earned income exclusion under Section 911. The moving expense, therefore, continues to remain deductible under Section 217, except to the extent that such expense is allowable under the earned income exclusion. The ratio between the earned income exclusion

⁵³ *Id.* at 366.

⁵⁴ 6 P-H TAX CT. MEM. ¶ 47,183 (1947).

⁵⁵ *Id.* at 47-669.

⁵⁶ Rev. Rul. 75-84, 1975 INT. REV. BULL. No. 11, at 8.

and gross income is the same as that between the moving expense deduction lost and the earned income exclusion.⁵⁷

If the employer later moves the taxpayer back to the United States, still retaining his services, the taxpayer will be permitted the normal deduction available under Section 217. However, if the employer moves the taxpayer back to the United States without employing him, the taxpayer would not be entitled to the moving expense deduction since he is not moving to a new principal place of work. The reimbursement is attributable to the past services performed in a foreign country and is eligible for the earned income exclusion with the disallowed deduction calculated proportionately.⁵⁸

4.02 Sale or Exchange of Residence

In 1974 Section 1034(a) provided that when a taxpayer sold his principal residence and purchased another residence, within a period of one year before to one year after the sale of the old principal residence⁵⁹ a gain was realized only to the extent that the adjusted sales price of the old residence exceeded the taxpayer's cost of the new residence. This section, however, has taken on a more enlightened application with the recent decision of *Clapham v. Commissioner*.⁶⁰ The Tax Court in *Clapham* found that a tax free home roll-over benefit was available three years after the petitioner moved from his former principal residence.

In May 1966, the petitioner placed his principal residence for sale, anticipating moving from San Francisco to Los Angeles due to a change in his employment. In August 1966, the petitioner and his family moved to Los Angeles where they rented a home, still attempting to sell their vacant former residence. In Spring 1967, the taxpayer not having received an offer to buy and being in financial difficulty accepted an offer to lease the home with an option to buy. In Spring 1968, the lessee moved out without exercising his option to buy. The house remained vacant until the Fall of 1968 when financial circumstances again dictated that another offer to rent be accepted. The house was again vacant by December 1968 and remained so until June 1969 when it was sold for \$32,000.00. Petitioner's basis was \$26,453.00. Meanwhile, in September 1968 the petitioner purchased a home in Los Angeles for \$31,500.00. Throughout the three-year period, the petitioner's sole intention was to sell the former residence, but from August, 1966 until

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ See Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 226-27 (1975). The Tax Reduction Act of 1975 extended the time on Section 1034(a) from one year to eighteen months. Pub. L. No. 94-12, § 207 (Feb. 18, 1975).

⁶⁰ 63 T. C. No. 46 (Jan. 30, 1975).

the time of the actual sale, the petitioner had received no offers to purchase the home.

Petitioner's claim for exclusion from gross income under Section 1034(a) was countered by the Commissioner's contention that the leaving of the old residence with no intention to return amounted to abandoning it as a principal residence. The Commissioner, therefore, concluded that when it was sold in 1969 it no longer qualified as a principal residence. Both parties stipulated that the sale of the old residence and the purchase of the substitute residence was accomplished within a one-year period. The court held that each case arising under Section 1034 must be decided on its particular facts and circumstances. The three-year period extending from ownership, vacancy, the rental of the former residence for a temporary period, and time of sale, this court went on to point out, was justified by the condition of the real estate market. Furthermore, the leases were not permanent, but rather, were used as a means to induce the purchase of the property.

The court discounted the abandonment argument of the Commissioner by affirming the position previously adopted in *John F. Bayley*⁶¹ and *Robert W. Aagaard*.⁶² In *Aagaard*, the taxpayer, while vacationing and with no intention to return, rented his home briefly before he sold it. The court held in favor of the taxpayer pointing out that it could not have been the intent of Congress to disallow the exclusion if temporary renting of the former residence occurred before its sale.⁶³

The Tax Court determined that Congress clearly intended that a taxpayer, under appropriate "facts and circumstances" could lease his property for a temporary period and still retain the benefits provided under Section 1034.⁶⁴ The court compared petitioner's plight to that of an involuntary conversion where Congress found the need for relief to be "especially clear."⁶⁵ In the instant case, under the facts and circumstances as presented, the lease was temporary in the manner contemplated by the legislative history and the subsequent regulations. For these reasons, the court held that petitioner was entitled to the Section 1034 benefits.

Caution should be exercised in the application of the court's position for there is strong indication that the Commissioner will appeal this decision.

⁶¹ 35 T. C. 288 (1960).

⁶² 56 T. C. 191 (1971).

⁶³ 63 T. C. at 282. The Tax Court referred to the following Congressional reports to support its determination: H. R. REP. NO. 586, 82d. Cong., 1st Sess. 28 (1951); S. REP. NO. 781 (Part 2), 82d. Cong., 1st Sess. 36 (1951).

⁶⁴ *Id.*

⁶⁵ *Id.*

Under the Tax Reduction Act of 1975⁶⁶ Section 1034(a) now allows nonrecognition of a gain realized on the sale of a taxpayers' principal residence if the taxpayer buys a new principal residence "within a period beginning eighteen months before the date of sale and ending eighteen months after such date . . . ,"⁶⁷ and the cost of purchasing the new residence exceeds the adjusted sales price of the old residence.

Section 1034(g) makes a provision for the nonrecognition of a gain on the sale of a principal residence owned by the taxpayer, his spouse or both if they invest the proceeds from the sale of the old principal residence into the new principal residence. However, no provision was made for the situation in which a husband and wife, who owned two separate homes that each used as his and her principal residence before they were married, sold both homes and invested their individual proceeds in a new home in which they took title jointly. Should they be required to recognize their respective gains on the sale?

By way of Revenue Ruling 75-238⁶⁸ the Internal Revenue Service has ruled that if the gains on the sale of their respective homes are reinvested into the new principal residence owned by both the husband and wife, there will be no recognition of their respective gains in the current year. However, if any portion of their respective gains are not reinvested in their new principal residence, that portion of the gain not reinvested will be taxable in the current year.

Finally, Treasury Information Release 1360⁶⁹ discusses the situation where a taxpayer, in one transaction, attempts to take advantage of both the Tax Reduction Act 1975 tax credit and the nonrecognition of gain under Section 1033 or Section 1034 of the Code. If, for example, the taxpayer sells his old principal residence for \$30,000.00 having an adjusted basis of \$20,000.00 and immediately uses the proceeds to purchase a new principal residence for \$40,000.00, which satisfies the requirement of Section 1034, and which also qualifies for the 5% tax credit, the tax credit will be calculated on an adjusted basis of \$30,000.00. The adjusted basis of the new principal residence is reduced by any gain from the sale of an old principal residence when that gain is not recognized and a tax benefit is received under Section 1033 or Section 1034. Therefore, the \$10,000 gain from the sale of the old residence reduces the adjusted basis of the new principal residence by \$10,000.00 for purposes of determining the amount of the tax credit. It must

⁶⁶ Act of March 29, 1975, Pub. L. No. 94-12 § 1, 89 Stat. 26.

⁶⁷ *Id.* at § 207.

⁶⁸ Rev. Rul. 75-238, 1975 INT. REV. BULL. No. 25, at 14.

⁶⁹ T. I. R. 1360, 6 P. H. 1975 FED. TAXES ¶ 55,194.

be remembered that the allowable tax credit does not in any way affect the taxpayer's basis in the new principal residence.

4.03 Travel Expenses

Section 162(a) provides a deduction for all the ordinary and necessary expenses incurred in carrying on a trade or business, including travel expenses such as meals and lodging. Interpreting this section, the Supreme Court has applied the "sleep or rest" rule,⁷⁰ also known as the "overnight" requirement. Under the interpretation given this section by the Supreme Court, a taxpayer must show that the nature of his employment is such that it is reasonable on such trips for him to require and to obtain sleep or rest during his release time in order to meet the demands of his job.

Two recent Revenue Rulings have also set forth guidelines concerning meals and lodging for truck drivers⁷¹ and railroad employees⁷² during layover periods. The Service will now take into consideration all the circumstances of the taxpayer's job, including any governmental regulations by which the taxpayer is limited. If the employee can show that he meets the "overnight" requirement by the nature of his duties and the duration of his trip, and that his release period is of such a duration as to allow him to obtain substantial sleep or rest, his expenses are deductible. Thus, if the layover is for a short period of time, during which the taxpayer cannot obtain substantial sleep or rest, his expenses for meals and related expenditures would not be deductible under Section 162(a) of the Code.⁷³

If a taxpayer is given allowances or reimbursements by his employer and need not account to his employer for them, the taxpayer must include these amounts in his gross income. If the employee must make an adequate accounting to his employer of his expenses and if the total amount of the allowance is equal to the expenses, the employee need not report the allowance and reimbursements on his federal income tax return. If the allowances and reimbursements exceed the expenditures, the employee must include the excess on his return. When the expenses exceed the allowances and the employee wishes to claim the excess as a deduction, they must meet the substantiation requirements of Section 274 of the Code.⁷⁴

4.04 Mileage Allowance

Revenue Procedure 75-3⁷⁵ allows employees and self-employed individu-

⁷⁰ *United States v. Correll*, 389 U.S. 445 (1967).

⁷¹ Rev. Rul. 75-168, 1975 INT. REV. BULL. No. 19, at 12, *superseding* Rev. Rul. 63-239, 1963-2 CUM. BULL. 87.

⁷² Rev. Rul. 75-170, 1975 INT. REV. BULL. No. 19, at 15.

⁷³ Rev. Rul. 75-168, 1975 INT. REV. BULL. No. 19, at 13.

⁷⁴ Rev. Rul. 75-170, 1975 INT. REV. BULL. No. 19, at 15.

⁷⁵ Rev. Proc. 75-3, 1975 INT. REV. BULL. No. 4, at 20, *amplifying* Rev. Proc. 74-23, 1974-2 CUM. BULL. 476.

als who have fully depreciated their business vehicles, pickup trucks and panel trucks, by the straight-line method to claim a standard mileage rate of 10 cents. If during the entire time that the taxpayer uses the vehicle, he determines his operating costs under the optional method,⁷⁶ then that entire time period is considered the useful life of the vehicle. The vehicle will not be deemed to have been fully depreciated until the end of that useful life. However, if the taxpayer used the actual cost method for at least one year during which time he used the vehicle for business purposes, then the useful life of this vehicle would be that period which the taxpayer used in calculating the straight-line depreciation for that year. It is immaterial which method the taxpayer used in subsequent taxable years, since the vehicle will be considered fully depreciated when the period upon which he has calculated the useful life ends. Thereafter he can take the standard mileage rate of 10 cents per mile.

4.05 Commuting Expenses

The taxpayer in *Alfred Patti*⁷⁷ was required by his employer to have his automobile available at his place of employment at all times. On the days that the taxpayer used his car at work, he was reimbursed by his employer at the rate of nine cents per mile for the total mileage driven that day, including his mileage to and from work which totaled sixty miles round trip. Since the taxpayer used his car only 63 days, he claimed a deduction for the unreimbursed costs of commuting to and from work and parking fees, less the cost of taking the train for the other 180 days. His claimed deduction came to \$1,053.14. The court conceded that the taxpayer met the "but for" test of proving that he would not have used his car but for the fact that it was required as a condition of his employment. However, the Tax Court denied the deduction after considering that the taxpayer was reimbursed for his commuting expenses on 63 days, stating: "Taking this into account, there is no basis for determining that the allowable deduction at 10 cents per mile for the use of the automobile exceeded the total reimbursement."⁷⁸

The Tax Court did not calculate the reimbursed commuting costs which totaled \$430.20 (9 cents per mile x 60 miles x 63 days). Therefore, the taxpayer's claimed deduction exceeded his actual reimbursed commuting expenses by \$712.94. The actual significance of the case appears to be that when appearing before the Tax Court, the taxpayer should have prepared all

⁷⁶ See Rev. Proc. 74-23, 1974-2 CUM. BULL. 476.

⁷⁷ 44 P-H TAX CT. MEM. ¶ 75, 107 (April 21, 1975).

⁷⁸ *Id.* at 515.

the necessary calculations, rather than relying on the court itself to analyze the figures.

The Internal Revenue Service has also allowed a deduction for commuting expenses claimed by a policeman for driving to and from work.⁷⁹ The taxpayer, employed by New York City but living in another part of the state, was required by New York City to be armed at all times when within the City of New York. The only public transportation available to the taxpayer from his home to work passed through the State of New Jersey which has a law prohibiting anyone who is not a New Jersey Police Officer or otherwise licensed by the State of New Jersey, from carrying a firearm while traveling on public transportation. The taxpayer applied for a permit and was rejected. The Service applied the "but for" test⁸⁰ and concluded that since the taxpayer would not have used his automobile *but for* the necessity of carrying his firearm, the deduction was permissible.

4.06 Medical Expenses

Section 213(e)(1)(b) of the Code defines medical care as "amounts paid . . . for transportation primarily for and essential to medical care" In *Weary v. United States*,⁸¹ the taxpayer claimed, as a medical expense deduction for 1967, five cents per mile plus the pro rata portion of the difference between the purchase price and sale price of a car bought and sold in that year. The car was used to transport Mrs. Weary for purposes of medical treatment, which was stipulated as a deductible purpose. Since Revenue Procedure 64-15 at that time allowed a deduction of only five cents per mile in the absence of a substantiated actual amount, the Commissioner disallowed the deduction. The taxpayer argued that the proportionate amount of the difference between the purchase price and the sale price is a proper deduction under Section 213 since it only required that there be an "amount paid" for medical transportation. The government's position was that depreciation is not an "amount paid" for purposes of Section 213. This position appears inconsistent with the government's position in *Commissioner v. Idaho Power Co.*⁸² in which the Supreme Court denied a claimed deduction for depreciation on equipment during the time which the equipment was used in constructing capital improvements. In that case the Supreme Court agreed with the Commissioner that, since Section 263 requires that "amounts paid out" for capital improvements be capitalized, the deprecia-

⁷⁹ 6 P-H 1975 FED. TAXES ¶ 55, 148 (private determination letter dated 2-14-75 to Police Officer William Addie).

⁸⁰ Rev. Rul. 63-100, 1963-1 CUM. BULL. 34.

⁸¹ 510 F.2d 435 (10th Cir. 1975).

⁸² 418 U.S. 1 (1974). See Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 241 (1975).

tion on the equipment should be regarded as an "amount paid out" for the improvement and therefore be capitalized.⁸³ The *Weary* Court distinguished *Idaho Power*, as a question involving the timing of a depreciation deduction, from the present case, which involves the question of the allowance of a deduction.⁸⁴ On the basis of that distinction, the Tenth Circuit determined that depreciation is not an amount paid within the meaning of Section 213 and disallowed the deduction.⁸⁵

In Revenue Ruling 75-230,⁸⁶ the Service set forth guidelines for both the recovery in a personal injury suit of medical expenses incurred and previously deducted, and the recovery in a personal injury suit for future medical expenses. Under this ruling, if a taxpayer who suffers a personal injury takes a medical deduction for his medical expenses, and then subsequently enters into a settlement of the personal injury suit, the taxpayer must report income to the extent of the previously allowed medical expense deductions or the amount of the settlement, whichever is the lesser. However, if the personal injury settlement contains an express allocation for previously paid medical expenses, it will be presumed correct unless it is unreasonable.

If the taxpayer enters into a settlement which allocates a specific amount for future medical expenses, the taxpayer will be denied future medical expense deductions until his future medical expenses exceed the amount specified. When this occurs, the deduction will be allowed only to the extent his actual expenses exceed that amount specified in the settlement.

4.07 Casualty Losses

In the 1975 case of *Robert M. Miller*,⁸⁷ the Tax Court re-affirmed its position under Section 165(c)(3), which limits deductible losses to those losses of property owned by the taxpayer claiming the loss. In *Miller*, petitioner in exchange for his personal transportation agreed to deliver an auto owned by Avis Rent-A-Car Systems, Inc., from Florida to New Orleans, Louisiana. Under the arrangement, petitioner paid no rental fee and was not covered by insurance. While en route, petitioner damaged the auto in the amount of \$2,434.64. Avis instituted suit against petitioner for the damages to its automobile, which resulted in a settlement of \$1,300.00. On petitioner's tax return for that year, he claimed the \$1,300.00 paid to Avis less the \$100.00 deductible, as a casualty loss. The Commissioner disallowed the claim.

⁸³ 418 U.S. at 16-17.

⁸⁴ 510 F.2d at 437.

⁸⁵ *Id.*

⁸⁶ Rev. Rul. 75-230, 1975 INT. REV. BULL. No. 25, at 6.

⁸⁷ 44 P-H TAX CT. MEM. ¶ 75, 110 (April 21, 1975).

Section 165(b) provides that the basis for determining the amount of deduction for any loss shall be the adjusted basis provided in Section 1011. A taxpayer has a basis only in property in which he has an ownership interest.⁸⁸ In *Draper v. Commissioner*,⁸⁹ the Tax Court held that the taxpayers were not entitled to a deduction for a casualty loss caused by fire, even though the destroyed property was owned by an adult daughter who was still dependent on taxpayers for her support. The court in *Draper* reasoned:

Deductions are allowed to taxpayers only by virtue of legislative grace and, to qualify, a taxpayer must prove he comes squarely within the authorizing statute. Basic in the law is the requirement that to support a deduction for loss of property, the claimant must have been the owner of the property at the critical time.⁹⁰

The court in *Miller* re-affirmed the rule laid out in *Draper* and concluded that since the petitioner did not own the auto, he had no basis from which to calculate a loss. Therefore, the loss was not deductible.⁹¹

An alternative argument, offered by the petitioner was that to allow a deduction for casualty loss only to the owner of the property, and not to non-owners of property who made payments associated with owner's property damages was unconstitutional. The Tax Court rejected that proposition, stating that a legislative classification will not be set aside if it is rationally justified.⁹²

In determining the amount of loss deductible under Section 165 of the Code, two methods of valuation are acceptable: (1) the decrease of the fair market value as a result of the casualty; and, (2) the actual cost of repairs.⁹³

In *Anna Marie Hagerty*,⁹⁴ the court applied the decrease in fair market value as a result of a casualty in order to determine the loss deduction. Petitioners' residence had a fair market value of \$78,000.00. A fire seriously damaged the property resulting in an immediate after casualty fair market value of \$35,000.00 as determined by evidence accepted by the court. Petitioners' fire insurance paid to repair the home at a cost of \$33,504.57. Although the repair work was satisfactory, it did not restore the residence to its pre-fire condition or value. The petitioners' contended that since the

⁸⁸ *Helvering v. Owens*, 305 U.S. 468 (1939).

⁸⁹ 15 T. C. 135 (1950).

⁹⁰ *Id.*

⁹¹ 44 P-H TAX CT. MEM. ¶ 75, 110, at 522.

⁹² *Id.*

⁹³ Treas. Reg. § 1.65-7(a)(2).

⁹⁴ 44 P-H TAX CT. MEM. ¶ 74, 066 (March 4, 1975).

fire insurance compensation did not fully restore the residence to its pre-fire condition or value, that a casualty loss was sustained in the amount of the difference between fair market value before and fair market value after the casualty. The Tax Court agreed and held the loss was the difference between the fair market value of the property before and after the fire (\$78,000.00 - \$35,000.00), less the insurance compensation received (\$33,504.57), and the \$100.00 deduction required by Section 165, thus netting the taxpayer a deductible loss in the amount of \$9,395.43.⁹⁵

The implementation of the fair market value formula, as determined in *Hagerty*, more accurately measures the actual loss suffered than the cost of repairs formula. This is particularly true when repairs do not restore the property to pre-loss condition.

4.08 Prepaid Feed Expenses

To determine the deductibility of a farmer's prepaid feed expense, the Service published a three-part prepaid feed test.⁹⁶ The validity of this ruling was questioned in *Cattle Feeders Tax Committee v. Schultz*,⁹⁷ where the taxpayer sought to enjoin the Service from enforcement of the ruling. The trial court ruled in favor of the taxpayer, but, on appeal was reversed by the Tenth Circuit.

The court of appeals determined that the action to enjoin the enforcement of the ruling was banned by the Anti-Injunction Act,⁹⁸ and that no special circumstances existed which would prevent the application of the Act.⁹⁹

The Service has now republished the 1973 Ruling without change.¹⁰⁰ To properly deduct prepaid feed bills, a cash-basis farmer must be able to show that:

- (1) the expenditure is for the purchase of feed rather than a deposit;
- (2) the prepayment is made for a business purpose and not for tax avoidance; and,
- (3) the deduction will not result in a material distortion of income.

To meet the requirements in section (1) above, the taxpayer must show that the expenditure was made pursuant to a binding commitment for

⁹⁵ *Id.* at 354.

⁹⁶ Rev. Rul. 73-550, 1973-2 CUM. BULL. 108.

⁹⁷ 34 Am. Fed. Tax R. 2d 74-5948 (10th Cir. 1974), *rev'g* 33 Am. Fed. Tax R. 2d 74-428 (W. D. Okla. 1973). See Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 236 (1975), for a discussion of the district court's opinion in this case.

⁹⁸ INT. REV. CODE OF 1954, § 7421(a).

⁹⁹ 34 Am. Fed. Tax R. 2d 74-5948.

¹⁰⁰ Rev. Rul. 75-152, 1975 INT. REV. BULL. No. 17, at 15.

a specific quantity at a specific price, and that the taxpayer cannot, under a contract provision or by way of business custom, obtain a refund or a repurchase. The ruling lists factors that are indicative of a deposit rather than a payment: the lack of specific quantity terms; the right by the taxpayer to a refund of any unapplied credit at the end of the contract; the right by the taxpayer to substitute other goods or products of the supplier for the feed; and, the seller's treatment of the expenditure as a deposit.

To meet the second part of the test, the taxpayer must show that the prepayment was made for a business purpose and not merely for tax avoidance. The Service states that business purposes include establishing a guaranteed feed supply source, obtaining preferential treatment in anticipation of a feed shortage, and establishing a maximum price.

The third part of the test is that the expenditure cannot result in a material distortion of the taxpayer's income. Section 446(b) of the Code is analogous to this third requirement, and provides that when the taxpayer's method of accounting does not clearly reflect income, the computation of the taxpayer's income will be made under the method which the Commissioner believes more accurately reflects the taxpayer's income. Since the Service has had the option of applying Section 446(b) in the past, its inclusion as a separate part of the prepaid feed expense test, is probably an indication by the Service that it intends to use this Section more in the future than it has in the past. Some of the factors listed by the Service to be considered in determining whether the taxpayer has met this part of the test are: the customary business practice of the taxpayer in conducting his livestock operations; the amount of this year's expenditure in relation to past years' expenditures; the time of the year in which the expenditure was made; and, the materiality of the expenditure in relation to the taxpayer's income for the year.

4.09 Premature Deposit Withdrawal Penalties

Interest on a time savings account which is forfeited as a penalty for early withdrawal is included in gross income, but may be deducted in arriving at adjusted gross income.¹⁰¹ Revenue Ruling 75-20¹⁰² describes the procedure to be used for making the above-the-line deduction. The taxpayer must file entry on Form 1040, the amount of the interest forfeiture between lines 38 and 39, indicating "forfeited interest penalty" to the left of the entry, and including the entered amount in the total for line 43 (total adjustments to income). The financial institution with which the taxpayer has dealt is to

¹⁰¹ Act of October 26, 1974, Pub. L. No. 93-483, § 6, 88 Stat. 1457, *amending INT. REV. CODE OF 1954*, § 62.

¹⁰² 1975 INT. REV. BULL. No. 3, at 5.
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furnish information on the amount deductible, pursuant to guidelines found in Revenue Ruling 75-21¹⁰³ established for such calculation.

4.10 Entertainment Expenses

In 1962, Congress enacted Section 274 to the Internal Revenue Code in order to curb extensive entertainment expense deductions. Prior to this time, the courts relied on the *Cohan* rule,¹⁰⁴ which allowed unsubstantiated entertainment expenses by accepting approximations of the taxpayer's expenses. Section 274(a)(1)(B) denies any deduction unless the taxpayer shows: (1) that the facility was "used primarily for the furtherance of the taxpayer's trade or business"; and, (2) that the particular expenses were "directly related to the active conduct of such trade or business." Under Section 274(d) the taxpayer has the added burden of substantiating the expenses claimed and the business relationship to those expenses.¹⁰⁵

In *Handelman v. Commissioner*,¹⁰⁶ the taxpayer claimed an entertainment expense deduction for his 46-foot off-shore sailing sloop on which he allegedly entertained clients and potential clients in connection with his law practice. Since the Code of Professional Responsibility prohibits attorneys from advertising, the taxpayer argued that he maintained his sailboat to "sell himself" to wealthy individuals. It is interesting to note that from his practice of law, the taxpayer reported a loss in 1963 of \$18,930, a gain in 1964 of \$2,024, and a gain in 1965 of \$6,183.

The court of appeals placed considerable emphasis on the fact that most of the guests in the taxpayer's sloop were not clients but persons whom the taxpayer hoped would become clients. It also noted that the taxpayer avoided conducting actual business on the sloop for fear of encroaching on the glamorous atmosphere he wished to create. The court concluded that the boat was used primarily to establish good will and not for a specific business purpose as required by the statute. Even if the taxpayer could show a specific business purpose, he failed to maintain adequate records establishing "the time and place of each use of the boat, the business purpose pertaining thereto or the business relationship to the taxpayer of the persons using the boat."¹⁰⁷ Thus, the deduction would have been disallowed under Section 274(d) even if a specific business purpose could have been shown.

4.11 Unreasonable Compensation

The question of what is a "reasonable allowance for personal services"

¹⁰³ 1975 INT. REV. BULL. No. 3, at 39.

¹⁰⁴ *Cohan v. Comm'r.*, 39 F.2d 540 (2nd Cir. 1930).

¹⁰⁵ Treas. Reg. § 1.274-5.

¹⁰⁶ 509 F.2d 1067 (2nd Cir. 1975).

¹⁰⁷ *Id.* at 1075.

under Section 162(a)(1) has been frequently litigated especially in the area of closely held corporations.¹⁰⁸ In *Albert VanLuit Co., Inc.*,¹⁰⁹ the corporation established a compensation plan providing for a base salary plus 30 percent of the profits as a salary for the 50% shareholder-president. The plan was followed for twenty years and in 1969 the formula resulted in a total annual salary of over \$195,000. The Service contended that the salary was unreasonable by producing evidence of compensation paid to presidents of certain companies in the wallpaper industry. The Tax Court held that the salary was reasonable since: (1) it was the product of an arm's-length bargain between the president and an independent majority of the board; (2) the plan was in effect before any services were rendered by president; (3) the corporation's phenomenal success was due entirely to the president's efforts; (4) the president was an acknowledged genius in the wallpaper industry; and, (5) the compensation was reasonable under all the circumstances.¹¹⁰

In a related area the Fifth Circuit, in *Tulia Feedlot, Inc. v. United States*,¹¹¹ decided the question of whether a corporation may deduct fees paid to its stockholder-directors for their personal guarantees on loans to the corporation. The taxpayer was a closely-held corporation with almost all of its outstanding stock owned by its thirteen directors. Eleven of the directors held equal amounts of stock while the other two directors, a father and his son, each owned one-half the number of shares owned by the other eleven shareholders. As commonly is the case in a closely-held corporation, the directors were asked to guarantee loans to the corporation by its bank. Each guaranteed an amount equal to his proportionate ownership of the stock. The guarantees were routinely made by the directors, without compensation, until July of 1970 when the directors voted to pay each shareholder-guarantor an annual fee, equal to three percent of the amount guaranteed by the shareholder.

The court of appeals noted that until 1972, the taxpayer had never paid a dividend, even though it had more than ample retained earnings. Every year the directors had discussed the possibility of declaring a dividend, since many directors desired a more substantial return on their investment. The board, however, always voted against it. For these fees to qualify as ordinary and necessary business expenses under Section 162(a), the court concluded that "they must be appropriate, helpful, and of a common or frequent occurrence in the type of business carried on by the taxpayer."¹¹²

¹⁰⁸ See Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 237 (1975).

¹⁰⁹ 43 P-H TAX CT. MEM. ¶ 75, 056 (March 13, 1975).

¹¹⁰ *Id.* at 320.

¹¹¹ 36 Am. Fed. Tax R. 2d 75-5078 (5th Cir. 1975).

¹¹² *Id.* at 75-5080.

The test employed by the court of appeals to determine whether the fees were "ordinary and necessary" was whether a hard-headed businessman under the circumstances, would have incurred the expenses."¹¹³ The court held that in the absence of evidence demonstrating that it was customary for businesses, similar to petitioner's, the court could not properly find "that the guaranty was an ordinary and necessary business expense because it could not be sufficiently informed as to the economic realities of the transaction."¹¹⁴

In its opinion in the present case, the court sought to distinguish the case of *A. A. & E. B. Jones Co.*¹¹⁵ In the *Jones* case, the Tax Court allowed a corporation's deduction of guarantor's fees paid to two shareholders as an ordinary and necessary business expense. In *Jones*, however, the court found that the guarantees could have been obtained elsewhere and that the fees were reasonable in comparison to the amounts normally charged. *Tulia* presented no evidence to show that the fees were customary or reasonable in amount. Thus, the Fifth Circuit appears to have based its decision upon the failure of the taxpayer to substantiate the "reasonableness" of the fees rather than on the invalidity of such a deduction.

4.12 Interest Expense

In *Israelson v. United States*,¹¹⁶ the taxpayer invested a portion of the substantial profit he made in 1965 from a real estate venture in tax-exempt bonds. By January 1, 1967 the taxpayer owned tax-exempt bonds totaling \$360,000. During the years 1964-67, the taxpayer and another individual entered into a joint venture, which purchased real estate and financed the acquisitions with purchase money mortgages. The taxpayer also acquired a loan previous to 1965, which was satisfied in July of 1965, but shortly thereafter he borrowed again. The balance due on the loan totaled \$230,000 during most of 1966 and between \$136,000 and \$384,000 in 1967 with an average monthly balance of \$254,000. None of the proceeds of the loan were used to purchase the tax-exempt bonds; nor was the collateral securing the loan ever tax-exempt bonds. The Service disallowed the interest on the loan and purchase money mortgages in 1967 under Section 265, which provides that no deduction shall be allowed for interest "incurred or continued to purchase or carry obligations . . . the interest of which is wholly exempt . . ." The Service argued that the interest paid on the bank loan and purchase money mortgages, although not interest on indebtedness

¹¹³ *Id.* at 75-5081.

¹¹⁴ *Id.* at 75-5082.

¹¹⁵ 29 P-H TAX CT. MEM. ¶ 60, 284 (1960).

¹¹⁶ 33 Am. Fed. TAX R. 2d 74-451 (D. Md. 1973).

incurred to purchase the tax-exempt bonds, was interest on indebtedness *incurred* or *continued* to carry the tax-exempt bonds. The district court found a sufficiently direct relationship between the debt and the carrying of the tax-exempt bonds by the taxpayer's overall investment plan to justify the disallowance of the interest deduction on the taxpayer's loan. However, the court allowed the interest deduction on the purchase money mortgages since it found other considerations, such as business reasons and the desires of the fellow venturers as to how the purchases should be financed, to justify the conclusion that the purchase money mortgages were not used to enable the taxpayer to continue carrying the tax-exempt bonds.

The taxpayers received even more of a setback before the Eighth Circuit Court of Appeals in the case of *Levitt v. United States*.¹¹⁷ The taxpayers, husband and wife, borrowed substantial sums from their bank to purchase United States Treasury Bonds at a discount. The bonds were to be redeemed at par by their estates for the purposes of paying federal estate taxes. Although the wife owned tax-exempt municipal bonds, her loans from the bank were used only to finance her Treasury bond purchases. The Treasury bonds were the only collateral held by the bank as security for the loans. In addition to the husband's loans for Treasury bonds, he secured loans to purchase the insurance policies on his life, carried by his employer. Purchases of land, other real estate investments and business ventures were also financed through loans. The husband deposited with the bank tax-exempt bonds, Treasury bonds, and life insurance policies as collateral for his loans.

The court of appeals relied on *Israelson* for the basic principles to be applied in the immediate case:

The following principles are well established. Section 265(2) does not become operative merely because the taxpayer incurred or continued indebtedness at the same time that he held tax-exempt securities. Rather, the Commissioner must establish a sufficiently direct relationship between the debt and the carrying of the tax-exempt bonds. The touchstone for decision is the purpose of the taxpayer in incurring or continuing the indebtedness.¹¹⁸

In deciding whether the interest on the loans which were acquired to finance the purchase of Treasury bonds was deductible, the court of appeals stated that, although the borrowing may have been advantageous for federal estate tax purposes, this did not necessarily show that the

¹¹⁷ 36 Am. Fed. Tax R. 2d 75-5117 (8th Cir. 1975).

¹¹⁸ *Id.* at 75-5119, quoting 33 Am. Fed. Tax R. 2d 74-451 (D. Md. 1973).

taxpayers' purchases and holdings of the tax-exempt securities were unrelated. In the opinion of the court, "the absence of any adequate business justification for the loans compels the conclusion that the taxpayer borrowed money in order to return his or her tax-exempts."¹¹⁹ Hence the interest on the loans which were secured to continue carrying the tax-exempt bonds, was nondeductible.

The trial court was also of the opinion that the loans, used to finance the husband's purchase of insurance policies, land, and business ventures, had no direct relationship to the carrying of the tax-exempts and, therefore, the interest was properly deductible. However, the court of appeals, relying on the fact that the borrowings, underlying the husband's investments were demand notes or notes with a maturity of less than a year, found the crucial point to be that, with each renewal of the loans, the husband was, in reality, maintaining the collateral to partially support his borrowings. Therefore, the court denied the claimed deduction.¹²⁰

The Eighth Circuit did not address itself to the question of whether business motives should be considered in determining the husband's method of financing his investments. The court's mechanical test of deciding whether tax-exempts are used as security oversimplifies the problem. Although the court quoted with apparent approval from *Israelson*, the two cases cannot be reconciled. It is this writer's opinion that the business motive test as set forth in *Israelson* is the better approach.

4.13 Contingent Liability Trust Fund

Generally, no deduction is permitted for additions to contingency reserves or accrued contingent liabilities.¹²¹ However, in *Crescent Wharf & Warehouse Co. v. Commissioner*,¹²² the Ninth Circuit allowed the self-insuring taxpayer to deduct \$266,000 of uncontested Workman's Compensation liabilities which it had accrued for 1966. Relying on the language in Section 461(a) of the Code¹²³ and its accompanying regulations,¹²⁴ the court initially determined that since the taxpayer had acquiesced

¹¹⁹ *Id.* at 75-5120.

¹²⁰ *Id.* at 75-5122.

¹²¹ *American Auto Ass'n. v. United States*, 367 U.S. 687 (1961); *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961).

¹²² 36 Am. Fed. Tax R. 2d 75-5246 (9th Cir. 1975).

¹²³ INT. REV. CODE OF 1954, § 461(a), reads: "The amount of any deduction or credit allowed by this subtitle should be taken for the taxable year under the method of accounting used in computing taxable income."

¹²⁴ *Treas. Reg.* § 1.461-1(a)(2), states:

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy . . . [T]he fact that the exact

to liability for the claims in question, all events had occurred which were necessary to fix the taxpayer's liability. The court also found that the amount of the claims could be determined with reasonable accuracy and remanded the case to the Tax Court to permit the taxpayer to establish the reasonableness of his accruals.

Section 461(f) allows an accrual-basis company to take a current deduction, if the company transfers money or property beyond its control to pay future liabilities being currently litigated. However, there has been a dispute as to the validity of Treasury Regulation Section 1.461-2(c)(1), which states that a transfer in order to be considered valid under Section 461(f)(2), must be made

. . . (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest¹²⁵

The controversy is whether the claimant-beneficiary must sign the trust agreement, as a prerequisite for the taking of a current deduction for the transfer of funds to a trust, established for the purpose of satisfying an asserted liability which is still in litigation. The question was answered in *Poirier & McLane Corp.*,¹²⁶ where the Tax Court held that in order for the deduction to be held valid the claimant-beneficiary did not have to sign the trust agreement.

The case involved a construction company that contracted to do work for the New York City Transit Authority and New York State. The construction company as part of the agreement held both the New York City Transit Authority and New York State harmless for any damages arising from their construction work. While performing the contract, damage occurred to property located near the construction sites, occasioning suits for trespass and negligence totaling \$14,781,150, against the petitioner. The petitioner set up a trust fund, in the amount of \$1,100,000, to pay the obligations expected to occur from the current litigation. The trust fund was in the control of a trustee and the petitioner had no control over the funds. The construction company took a tax deduction pursuant to Section 461(f), for the year in which the funds were transferred.

amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

¹²⁵ Treas. Reg. § 1.461-2(c)(1).

¹²⁶ 63 T. C. No. 55 (March 10, 1975).

The Internal Revenue Service disallowed the petitioner's deduction claiming that: (1) the company was not in compliance with Section 461(a),¹²⁷ and (2) since the funds were not placed "beyond the control" of petitioner and the beneficiary did not sign the trust agreement, the petitioner failed to satisfy the requirements of Section 461(f), as amplified by Treasury Regulation 1.461-2(c)(1).¹²⁸

The Tax Court ruled that the deduction was taken in the proper year since the purpose of Section 461(f) was to allow the deduction in the year the money was transferred to the trust account rather than in some later year when the case was settled.¹²⁹ The purpose of permitting the deduction in the year the money is transferred into trust was to match the receipts and disbursements in the year in which they occurred.¹³⁰

The second contention of the IRS was also overruled by the court. The court found that the petitioner had no right to revoke the trust but he was to receive the remainder after the disposition of the claim. The petitioner could not have received or controlled the trust until all the claims were paid. Therefore, the petitioner made "a genuine transfer of funds beyond its control . . ." within the meaning of Section 461(f)(2), as interpreted by Treasury Regulation Section 1.461-2(c)(1).¹³¹

The court also ruled that the claimant-beneficiary did not have to sign the trust agreement in order for the deduction to be held valid. However, this did not require the Regulation to be declared invalid. "Properly interpreted, the Regulation simply does not require the signatures of the claimant-beneficiaries in this case."¹³²

The court, in reaching its conclusion relied primarily on the legislative history¹³³ of Section 461(f), which does not suggest that the person asserting the claim must have signed the trust agreement. The court also referred to the case of *In re Prudence Co.*,¹³⁴ which held that: "The failure to notify the cestui que trust of the creation of the special interest in his favor

¹²⁷ INT. REV. CODE OF 1954, § 461(a): "The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

¹²⁸ 63 T. C. at 318.

¹²⁹ *Id.* at 318-19, relying on S. REP. NO. 830 (Part 2), 88th Cong., 2d Sess. (1964), reprinted in 1964-1 (Part 2) CUM. BULL. 604-05, 745-48.

¹³⁰ *Id.*

¹³¹ *Id.* at 320.

¹³² *Id.*

¹³³ S. REP. NO. 830 (Part 2), 88th Cong., 2d Sess. (1964), reprinted in 1964-1 (Part 2) CUM. BULL. 604-05, 745-48.

¹³⁴ 24 F. Supp. 666 (E. D. N.Y. 1938).

does not prevent the creation of a trust."¹³⁵ Furthermore, the rights of the claimant-beneficiaries in the trust agreement would be exactly the same whether or not they signed the instrument. The deduction was, therefore, held to be valid.

However, in dissenting, Justice Hall stated that a literal interpretation of the statute requires the claimant-beneficiaries to sign the trust agreement. If the claimant-beneficiaries do not sign the trust, the petitioner would be able to set up a "secret trust" which would give the petitioner a tax deduction without giving the claimant-beneficiaries knowledge of the trust arrangement. Justice Hall further stated that this arrangement served no business purpose and that it was not the intent of the statute to allow such an arrangement.¹³⁶

However, this arrangement still does not affect the claimant-beneficiaries' rights under the trust. If they received a judgment in their favor, the petitioner would probably disclose the trust rather than have a lien put on its property. If the petitioner did not disclose the trust it would be revealed upon examination of its assets,¹³⁷ and the claimant-beneficiaries would be able to make their claims.

Clearly, there is no significant purpose to require the signature of the claimant-beneficiaries. The decision in this case will allow taxpayers to continue to take a deduction for the trust arrangement without having the claimant-beneficiaries sign the trust agreement. This is significant, since knowledge of the trust would clearly be a signal to the claimant-beneficiary that the settlor was admitting liability.

4.14 Ministerial Fees

Can a sole proprietor deduct fees paid to a minister for conducting prayer meetings, rendering personal and business advice to the proprietor and his employees, and performing various business-related tasks? In *Lionel F. Trebilcock*,¹³⁸ the petitioner was sole proprietor of a company engaged in the brokerage of wood products. He employed five people: his father, his brother, a secretary, a traveling salesman, and a minister. The minister conducted prayer meetings at which he tried to raise the level of spiritual awareness of the participants, advised the taxpayer and his employees concerning both their business and personal problems, and performed various business-related tasks. To assist the taxpayer with his business problems, the minister would turn to God in prayer and then propose an answer resulting

¹³⁵ *Id.* at 668.

¹³⁶ 63 T. C. at 322-23.

¹³⁷ N. Y. CIV. PRAC. LAW § 5223 (McKinney 1963).

¹³⁸ 64 T. C. No. 80 (August 7, 1975).

from that prayer. The solutions the minister offered came through prayer, from God, and were not based on his knowledge of the petitioner's business. The Tax Court denied the deduction for the prayer meetings, since the benefits were personal in nature and, therefore, nondeductible under Section 262. The advice rendered by the minister concerning the personal problems of the petitioner and his employees was found to be nondeductible for the same reason. Nor did the court permit a deduction for the business advice rendered the petitioner and his employees, since it did not meet the requirements of Section 162(a) that it be in the "ordinary" course of business. In reaching its position on this point, the court concluded: "Petitioner has offered no proof that his payments to Wardrop for solutions to business problems, considering the method Wardrop used, 'were ordinary' in his type of business."¹³⁹

However, the court did allow the deduction for the various business-related tasks and errands the minister performed for the taxpayer's company.

4.15 Office Furnishings

In *Leroy W. Gillis*,¹⁴⁰ petitioner's employer moved to a new office building, and each office was supplied with new furniture except for the petitioner's. This was due, in part, to a personality conflict between the petitioner and the person selected by his employer to decorate the new offices. The petitioner, a district sales manager for an insurance company, thinking it important to protect his image and maintain his status with respect to prospective clients, others he frequently saw in his office, and desiring not to cause any conflict between his supervisor and the decorator, purchased new furniture for his office at his own expense. The petitioner never sought or received reimbursement from his employer.

The court concluded that the petitioner's desire "not to upset the apple cart" and to protect his image as a successful district sales manager was sufficient reason to justify his expenditures. The court considered them "appropriate and helpful" and allowed the petitioner's depreciation expense.¹⁴¹

The petitioner also maintained an office in his home located fifteen minutes from his employer's office. His home office was used on weekday evenings to read new rules and regulations affecting insurance companies, to prepare weekly bulletins for his agents, and to maintain a small supply of forms for agents to pick up when they exhausted their own supply. The Commissioner maintained that since his employer's office was completely

¹³⁹ *Id.* at 473.

¹⁴⁰ 42 P-H TAX CT. MEM. 423 (1973).

¹⁴¹ *Id.* at 427

adequate and located nearby, the petitioner's deduction for home office expenses should be disallowed. In its opinion, however, the Tax Court stated:

Neither the absence of an employer requirement that a home office be maintained nor the mere existence of duplicate facilities in and of itself demands the disallowance of a deduction of home office expenses. Rather, the test is whether, like any other business expense, the maintenance of an office in the home is appropriate and helpful under the circumstances or simply serves the personal convenience of the taxpayer.¹⁴²

After consideration of the distance from the petitioner's home to his office, the hazards of working downtown at night, the nature of the work performed at home, and the fact that the office was maintained as a separate room for business use, the court concluded that the petitioner's home office was appropriate and helpful in performing his employment.

4.16 Rental Property Expenses

The Service has clarified its position on the deductibility of expenses associated with rental property when property is leased by the taxpayer to the taxpayer's relative at less than fair market value.¹⁴³ The expenses are not deductible under Section 162 or 212 since these sections require a profit motive. Under Revenue Ruling 75-14, property is held for the production of rents only when the *primary purpose* in holding the property is to produce rental income in excess of the expenses attributable to the property. Therefore, these expenses are governed by Section 183 which is concerned with activities "not engaged in for profit." Under this section, the expenses are deductible from adjusted gross income when computing taxable income. Therefore, these are deductible only if the taxpayer itemizes his deductions.

The interest and taxes resulting from the rental property are deductible in full since these are allowable under Sections 163 and 164. The operating expenses are deductible only to the extent that the gross income from the rental house exceeds interest and taxes. Finally, depreciation is deductible, only to the extent that the gross income from the rental exceeds the interest, taxes, and operating expenses.

4.17 Improvement and Preservation of Existing Income

In *Colorado Springs National Bank v. United States*,¹⁴⁴ the Tenth Circuit decided that certain expenditures in the areas of computer costs, credit checks, and promotional activities incurred by the taxpayer in starting up

¹⁴² *Id.* at 425.

¹⁴³ Rev. Rul. 75-14, 1975 INT. REV. BULL. No. 2, at 7.

¹⁴⁴ 34 Am. Fed. Tax R. 2d 74-6166 (10th Cir. 1974), *aff'g* 32 Am. Fed. Tax R. 2d 73-6175.

its Master Charge credit system were deductible as business expenses under Section 162. The government contended that the expenses were pre-operation costs for entry into a new business, therefore failing to meet the requirement of Section 162, that they be incurred in carrying on a trade or a business. The Court rejected this argument stating that credit cards merely enabled the bank to carry on an old business (financing consumer transactions) in a new way. Since the expenses were for the preservation and improvement of existing income, they were ordinary under Section 162.

In *James O. Gould*,¹⁴⁵ the taxpayer was the sole shareholder of a corporation, which he organized to perform residential plumbing services. He was also a 25 percent shareholder, director, and full-time employee of a second corporation formed to handle industrial plumbing services. His position with the industrial concern was that of a purchasing agent, thus permitting him to come into direct contact with manufacturers who supplied plumbing materials. His wholly owned residential corporation experienced financial difficulties and eventually one of its creditors garnisheed its bank account and accounts receivable. Since some of the creditors with whom the taxpayer dealt, while working for the industrial concern, were also creditors of his residential corporation, the other directors of the industrial corporation became apprehensive about the possible impact of the residential corporation's situation. The taxpayer believed that he would have to settle the affairs of his wholly owned residential corporation or his employment with the industrial corporation would be terminated. The taxpayer and four of the residential corporation's creditors reached a compromise in which the taxpayer agreed to pay them approximately 75 percent of the face value of his corporation's obligations even though he was not personally liable. The taxpayer claimed a business deduction under Section 162, which permits as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The Commissioner disallowed the deduction claiming that it constituted a contribution to capital. The Tax Court, however, allowed the deduction under Section 162, since the taxpayer's employment with the industrial corporation constituted a business. The court found that the evidence clearly showed that the taxpayer's motive was to preserve his employment with the industrial corporation. The payments were not made to revitalize or enhance his investment in his own corporation or to retain his personal reputation. Furthermore, he believed his job with the industrial corporation to be in jeopardy. The court said the taxpayer was required only to prove that his

¹⁴⁵ 64 T. C. No. 11 (May 1, 1975).

motive for making the payment was to protect his job with the industrial corporation and the taxpayer met that burden.¹⁴⁶

4.18 Home Office Expense

Utilizing the "ordinary and necessary expenses" provision of Section 162(a) of the Code, executives and employees have been successful in recent years in obtaining deductions for those expenses incurred in maintaining offices in their homes.¹⁴⁷ The Tax Court and Second Circuit have allowed the deduction under Section 162(a) if the home office expenditure was "appropriate and helpful" to the taxpayer's business.¹⁴⁸ In *Stephen A. Bodzin*,¹⁴⁹ the taxpayer, an attorney in the Washington office of the Internal Revenue Service, used his den in the evenings and on weekends for reading and writing proposed ruling letters, published rulings, requests, for technical advice and opinions. The den was also used by the taxpayer for various non-business purposes.

The taxpayer claimed a deduction for \$100 of the \$2,100 annual rent paid for his apartment. The taxpayer was not required, requested, expected, or encouraged to work in the evenings or on weekends. Even though the taxpayer could have used his office in the Internal Revenue Building which was always open and not a long distance from his home, he preferred his den since it was more convenient and pleasant than remaining at or returning to his office. The Tax Court allowed the deduction finding that it made no difference that the taxpayer was not required to maintain a home office but did so only because he wanted to do a good job and liked his work. The court found the expenses were "appropriate and helpful" in the conduct of his business and were therefore "necessary" under Section 162(a).

Four judges dissented viewing the claimed deduction as a personal expense and not a business expense.

The Fourth Circuit reversed¹⁵⁰ relying on Section 262 of the Code, which provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." Quoting from the Supreme Court in *Idaho Power*,¹⁵¹ the court of appeals found that Section 161 provides that deductions specified in Part VI of the Code are subject to the exceptions in Part IX. Since Section 162 is in

¹⁴⁶ *Id.* at 64-75.

¹⁴⁷ See generally Briner, *Federal Income Tax Developments: 1973*, 7 AKRON L. REV. 188, 209 (1974).

¹⁴⁸ *Newi v. Comm'r.*, 432 F.2d 998 (2d Cir. 1970), *aff'g* 38 P-H TAX CT. MEM. 735 (1969).

¹⁴⁹ 60 T. C. 820 (1973).

¹⁵⁰ *Bodzin v. Comm'r.*, 509 F.2d 679 (4th Cir. 1975).

¹⁵¹ *Comm'r. v. Idaho Power Co.*, 418 U.S. 1 (1974).

Part VI and Section 262 is in Part IX, Section 262 takes precedence over Section 162.¹⁵² The Fourth Circuit noted that the Treasury Regulations under Section 262 specify that "a taxpayer who rents a property for residential purposes but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent."¹⁵³ Therefore, the court concluded that the taxpayer did not use his apartment as his place of business and therefore disallowed the deduction.

4.19 Legal Fee Splitting

In *Jimmie T. Jermigan*,¹⁵⁴ the petitioner expended \$75,000 in legal fees in connection with her divorce proceedings. Of that amount, \$2,000 was incurred in the securing of the divorce, \$23,000 was incurred in connection with the property settlement, and the remaining \$50,000 was allocated to the production and collection of alimony payments taxable to her under Section 71. By a mutual agreement, that was incorporated in the final divorce decree, the husband agreed to pay \$25,000 of the legal fees which he would not deduct on his tax return, and the petitioner agreed to pay the remaining \$50,000 "for that part of their professional services which pertains to her alimony arrangements."¹⁵⁵ The petitioner then deducted \$50,000 from her tax returns under the provisions of Section 212(1). The Commissioner maintained that the fee splitting agreement between the parties should be disregarded to the extent that it designated which payments were to be applied to the various portions of the fee. He argued that since two-thirds of the petitioner's total legal fees were incurred in the production and collection of income, only two-thirds of the actual amount expended by the petitioner should be permitted as a deduction under Section 212.

The Tax Court relied on *Marion R. Hesse*¹⁵⁶ in which the wife entered into two agreements with her attorney. One agreement was to pay him 10 percent of the value of any assets she received in the divorce settlement, and the other was for his fee in the divorce proceedings. In the divorce settlement, the husband agreed to pay the wife's legal fees for the divorce proceedings. The court in *Hesse* held that the fee paid by the wife for the divorce settlement was deductible by her under Section 212.

The Commissioner sought to distinguish the *Hesse* case from the present case on the ground that in the present case there was only one

¹⁵² 509 F.2d at 601.

¹⁵³ Treas. Reg. § 1.262-1(b)(3).

¹⁵⁴ 44 P-H TAX CT. MEM. ¶ 75, 132 (May 7, 1975).

¹⁵⁵ *Id.* at 75-602.

¹⁵⁶ 60 T. C. 685 (1973).

contract. The court termed this a "distinction without substance" and allowed the petitioner's claimed deduction.

The court concluded that the agreement between the petitioner and her husband, who were adverse parties, was "the best evidence of what portion of the total legal fees paid by the petitioner was incurred in connection with the production of alimony."¹⁵⁷

4.20 Employment Agency Fees

The Internal Revenue Service has reconsidered its position on whether employment agency fees are deductible.¹⁵⁸ For years the Service's position, one with which the Tax Court has not agreed,¹⁵⁹ has been that the deductibility of the fee was contingent upon the success of the agency in securing new employment. The Service has now acquiesced and will allow the deduction of agency fees regardless of whether the agency secures new employment.¹⁶⁰ There are some limitations. If the taxpayer is entering a new trade or business, the fees are not deductible even if employment is secured. However, if the individual is unemployed for a short period of time and obtains employment in the same trade or business he previously performed, the fee becomes deductible. In other words, the fee is not deductible where there has been a "substantial lack of continuity" between the past employment and the seeking of new employment or where the individual is obtaining employment for the first time.¹⁶¹

4.21 Acquisition of New Business

In *Johan Domenie*,¹⁶² the taxpayer resigned from his job in order to devote full time to the search of a new business. He placed advertisements in two journals and received a reply from a broker in Florida. The broker introduced the taxpayer to a businessman who was interested in divesting himself of his interests in one of his corporations. The taxpayer made several trips to the corporation's office, had an accounting firm make an audit of the corporation's books, contracted with a law firm to represent him in the acquisition, filed the articles of incorporation and bylaws, signed signature cards at the bank with which he expected to open the corporation's account and took an active part in managing the business, and familiarized himself with all aspects of the business. Shortly before the

¹⁵⁷ 44 P-H TAX CT. MEM. at 75-604, 75 605.

¹⁵⁸ Rev. Rul. 75-120, 1975 INT. REV. BULL. No. 15, at 7. David J. Primuth, 54 T. C. 374 (1970).

¹⁵⁹ See generally Briner, *Federal Income Tax Developments: 1973*, 7 AKRON L. REV. 188, 220 (1974).

¹⁶⁰ 1975 INT. REV. BULL. No. 15, at 6.

¹⁶¹ *Id.* at 8.

¹⁶² 44 P-H TAX CT. MEM. ¶ 75, 094 (Apr. 7, 1975).

closing date, the taxpayer discovered that the seller of the corporation was encountering financial difficulties in another of his corporations. Since the other corporation was a customer of the corporation that the taxpayer was about to acquire and owed the corporation money, the taxpayer became worried. Further investigation discovered that certain misrepresentations had been made to the taxpayer and some irregularities appeared in the corporation's books. The taxpayer went to Florida, discussed these problems with the broker, and decided to terminate the transaction. He claimed a deduction for all the expenses incurred in the proposed acquisition under Section 162(a)(2), 212(1), and 165(c)(2). Section 162(a)(2) allows as a deduction all the ordinary and necessary expenses incurred in a trade or business including travel expenses while away from home.

The Tax Court reasoned that the expenses were incurred in searching for and investigating a new business and that the taxpayer at that time was not engaged in any business thereby failing to qualify for a deduction under that section.¹⁶³ The court also disallowed the deductions under Section 212(1), which permits as a deduction all the necessary and ordinary expenses incurred for the production and collection of income. Since the purchase was never consummated, the taxpayer had no existing interest in any income producing asset and could not, therefore, rely on that section.

The taxpayer alternatively argued that the expenses were deductible under Section 165(c)(2), providing for "losses incurred in any transaction entered into for profit, though not connected with a trade or business." Conceding that the taxpayer had the requisite profit motive, the government argued that the proceedings had not reached the "transaction" stage. The court disagreed with the Service's position, finding the losses were not expenses incurred in the search for a suitable business, but occurred after the taxpayer thought he had found a business and was preparing to consummate the purchase.¹⁶⁴ The court allowed the deduction under Section 165(c)(2), for all except those incurred in placing the advertisements in the journals and the trip to Florida when the proposed acquisition was terminated.

4.22 Charitable Deductions

In *Haverly v. Commissioner*,¹⁶⁵ the Seventh Circuit reversed a district court decision which permitted the taxpayer to take a deduction for a donation of unsolicited sample books to a school library. *Haverly* gave the books, which had a fair market value of \$400.00, to the school library and claimed a \$400.00 charitable deduction on his income tax return. The

¹⁶³ *Id.* at 75-465.

¹⁶⁴ *Id.*

¹⁶⁵ 35 Am. Fed. Tax R. 2d 75-1082 (7th Cir. March 20, 1975).

school was free to utilize the books in any manner it chose. The taxpayer did not include the books' value as income to which the Commissioner took exception, citing, Section 61(a) of the Code which states that gross income "means all income from whatever source derived." The court of appeals held that although the books were unsolicited, once the taxpayer exercises "complete dominion" over the textbooks he has an "accession to wealth". The possession of the textbooks and their donation to the library and use as a charitable deduction are evidence that an income was "clearly realized" by the taxpayer. Therefore, "when a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the taxpayer's gross income."¹⁶⁶

The court's decision is consistent with a recent Revenue Ruling¹⁶⁷ which determined that when a newspaper's book reviewer donated to charitable organizations unsolicited books he received from publishers, the value of the deduction must be included in his gross income.

5.00 Tax Credit

5.01 New Housing Credit

Under the Tax Reduction Act of 1975,¹⁶⁸ a taxpayer who purchases a newly constructed home in 1975 will be eligible for a tax credit of five percent¹⁶⁹ of the purchase price of the home up to a maximum of \$2,000¹⁷⁰ and \$1,000 in the case of married taxpayers filing separate returns.¹⁷¹

To be eligible for the tax credit, the taxpayer must meet the following requirements:

- (1) The residence purchased must be new¹⁷² and be used as the taxpayer's principal residence.¹⁷³
- (2) The construction of the residence must have begun before March 26, 1975.¹⁷⁴

¹⁶⁶ *Id.* at 75-1084.

¹⁶⁷ Rev. Rul., 70-498, 1970-2 CUM. BULL. 6.

¹⁶⁸ Act of June 30, 1975, Pub. L. No. 94-45, § 401, 89 Stat. 236, amending Act of March 29, 1975, 94-12 § 208, 89 Stat. 26.

¹⁶⁹ INT. REV. CODE OF 1954, § 44(a).

¹⁷⁰ *Id.* § 44(b)(1).

¹⁷¹ *Id.* § 44(b)(3).

¹⁷² *Id.* § 44(e)(1). See T. I. R. 1360, 6 P. H. 1975 FED. TAXES ¶ 55, 194: "The residence must be new. A renovated building does not qualify as new for this purpose, regardless of the extent of the renovation."

¹⁷³ INT. REV. CODE OF 1954, § 44(e)(1)(A). See Section 44(c)(1) of the Code, which provides that the meaning of the term "new principal residence" for the purposes of Section 44 will be interpreted within the meaning of Section 1034.

¹⁷⁴ *Id.* § 44(e)(1)(A). See T. I. R. 1360, 6 P. H. 1975 FED. TAXES ¶ 55, 194. Construction is considered to commence when the actual physical work has occurred at the building site, i.e.,

- (3) The residence must be . . . acquired and occupied by the taxpayers after March 12, 1975 and before January 1, 1977.¹⁷⁵
- (4) The taxpayer must have entered into a binding contract for the purchase of the home before January 1, 1976. This does not apply to a taxpayer who is building his own residence.¹⁷⁶
- (5) If the taxpayer is building his own residence only that portion of the home constructed after March 12, 1975 will be eligible for the tax credit.¹⁷⁷
- (6) The taxpayer must attach to his return “. . . written certification (which may be in any form) signed by the seller of such residence . . .”¹⁷⁸ stating that the construction of the home began before March 26, 1975¹⁷⁹ and that “. . . the purchase price . . . is the lowest price at which the residence was offered for sale after February 28, 1975.”¹⁸⁰ The certification requirement does not apply to a taxpayer who is building his own home.

The Internal Revenue Service has warned that any seller who falsely certifies that a home was sold at its lowest price will be liable for both civil and criminal penalties.¹⁸¹ However, the tax credit will not be denied to the buyer because of the seller's false certification, providing that the taxpayer otherwise qualifies for the tax credit.¹⁸²

The Tax Reduction Act of 1975 limits the tax credit to only one residence of the taxpayer,¹⁸³ and will not allow the credit for residences purchased from certain persons who are related to the taxpayer.¹⁸⁴

In addition to these qualifying prerequisites, the taxpayer will have his

excavation. “Construction of a mobile home or a factory-built house is considered to commence when construction of important parts . . . is commenced.” *Id.* at 54,973.

¹⁷⁵ INT. REV. CODE OF 1954, § 44(e)(1)(B).

¹⁷⁶ *Id.* § 44(e)(1)(C).

¹⁷⁷ *Id.* § 44(e)(2). For example if a taxpayer builds a home that has a total cost of \$30,000 and a portion of the home costing \$10,000 was constructed before March 13, 1975 only \$20,000 will be considered eligible for the tax credit.

¹⁷⁸ INT. REV. CODE OF 1954, § 44(e)(4).

¹⁷⁹ *Id.* § 44(e)(4)(A).

¹⁸⁰ Act of June 30, 1975, Pub. L. No. 95-45 § 401, 89 Stat. 243, amending INT. REV. CODE OF 1954, § 44(c)(4)(B).

¹⁸¹ Act of March 29, 1975, Pub. L. No. 94-12, § 208, 89 Stat. 26, as amended, Act of June 30, 1975, Pub. L. No. 95-45, § 401, 89 Stat. 243.

¹⁸² T. I. R. 1360, 6 P. H. 1975 FED. TAXES ¶ 55, 194.

¹⁸³ INT. REV. CODE OF 1954, § 44(b)(2).

¹⁸⁴ *Id.* § 44(c)(3)(A). Such related persons “include only [the taxpayers] spouse, ancestors and lineal descendants . . .” However, certain related corporations, partnerships and trusts under Section 267 and 707(b) are also considered related for the purposes of this section.

tax credit recaptured if he sells his new residence within three years of the date of purchase.¹⁸⁵ However, there will be no recapture if the taxpayer:

- (1) buys a new principal residence;¹⁸⁶
- (2) dies within the three year period and his residence is sold;¹⁸⁷
- (3) disposes his residence due to its destruction;¹⁸⁸
- (4) disposes his residence "pursuant to a settlement in a divorce or legal separation proceeding where the other spouse retains the residence as principal resident";¹⁸⁹ or,
- (5) disposes his residence pursuant to any other type of involuntary conversion within the three year period.¹⁹⁰

6.00 Depreciation

6.01 Contracts of Professional Athletes

Section 167(a) of the Code provides the taxpayer a reasonable allowance in the form of a depreciation deduction for the exhaustion, wear and tear of property used in his trade or business. An intangible asset is a proper subject for depreciation, provided such asset has a finite useful life which may be estimated with reasonable accuracy.¹⁹¹

Depreciating the contracts of professional athletes has been a source of controversy since the mid-1930's.¹⁹² Although the position of the Internal Revenue Service on the subject has fluctuated since that time,¹⁹³ it is now firmly established that even a one-year player contract is depreciable in view of the option clause included in the standard player contract.¹⁹⁴ This clause restrains a player from playing for any team other than the one with which he has dealt one year after expiration of the original contract.

The taxpayer in *Laird v. United States*¹⁹⁵ was a minority stockholder in

¹⁸⁵ *Id.* § 44(d)(1).

¹⁸⁶ *Id.* § 44(d)(2). If a taxpayer sells his residence which qualified for a tax credit within three years of the date of purchase, but buys a new home within eighteen months or in the case of self construction within two years, and the proceeds from the sale are reinvested in the new residence, there will be no recapture of the tax credit.

¹⁸⁷ *Id.* § 44(d)(3)(A).

¹⁸⁸ *Id.* § 44(d)(3)(B).

¹⁸⁹ *Id.* § 44(d)(3)(C).

¹⁹⁰ *Id.* § 44(d)(3)(B).

¹⁹¹ Treas. Reg. § 1.167(a)-3.

¹⁹² *E.g.*, *Helvering v. Kansas City Am. Ass'n. Baseball Co.*, 75 F.2d 600 (8th Cir. 1935); *Comm'r. v. Chicago Nat'l. League Ball Club*, 74 F.2d 1010 (7th Cir. 1935); *Comm'r. v. Pittsburgh Athletic Co.*, 72 F.2d 883 (3rd Cir. 1934).

¹⁹³ *Compare* I. T. 2932, XIV-2 CUM. BULL. 61 (1935), with I. T. 2993, XV-2 CUM. BULL. 146 (1936); I. T. 4078, 1956-1 CUM. BULL. 39; [and] *Rev. Rul. 54-441*, 1954-2 CUM. BULL. 101.

¹⁹⁴ *Rev. Rul. 71-137*, 1971-1 CUM. BULL. 104; *Rev. Rul. 67-379*, 1967-2 CUM. BULL. 127.

¹⁹⁵ 35 AM. FED. TAX R. 2d 75-899 (N. D. Ga. 1975).

The Five Smiths, Inc., which had elected to be taxed as a Sub-chapter S Corporation. Five Smiths purchased, from the National Football League and its member teams, certain assets,¹⁹⁶ in order to operate the NFL franchise in Atlanta, Georgia. For tax purposes, the entire purchase price of the franchise (less franchise fee and deferred interest) was allocated by Five Smiths to the forty-two veteran player contracts acquired in the transaction, in spite of the fact that other substantial assets were also obtained.¹⁹⁷ The rationale proposed by the taxpayer for such allocation was the purchase agreement with the NFL, which specifically designated that amount as consideration for the veterans' contracts.

Although not disputing the useful life of five and one-quarter years assigned to these player contracts, an Internal Revenue Service audit resulted in disallowance of depreciation deductions taken against the contracts due to the inflated basis used in calculating the deductions. Whether the basis used by the taxpayer was accurate, or was assigned to achieve favorable tax consequences was a difficult matter for the court to resolve, as the taxpayer was able to produce expert testimony which supported his valuation.¹⁹⁸

In spite of this evidence, however, the district court concluded that the true substance of this transaction had been disguised by the formal agreement, and that the economic realities of the taxable event could be discovered only by disregarding the forms employed by the parties.¹⁹⁹

While agreeing with the taxpayer's valuation of the membership fee and deferred interest, the court found that the value of Atlanta's right to a pro rata share of television revenues, generated by a contract previously negotiated by the NFL, was substantial, even though it had been ignored by the taxpayer in computing the depreciable basis of the player contracts. Subtraction of these items from the total purchase price (\$8,500,000.02) yielded a value (\$3,445,871.02) which was allocated by the court between the player contracts and the franchise.²⁰⁰

Even though the court refused to accept the taxpayer's valuation of the veteran player contracts, it rejected the government's contention that it was impossible to establish a reasonably accurate basis for the depreciation of

¹⁹⁶ Among the assets acquired by The Five Smiths, Inc. were: Forty-two veteran player contracts, the right to participate in the college selection draft, the right to share equally with other member teams in television revenue, the exclusive right to exhibit NFL football within 75 miles of Atlanta, and the benefit of league rules and administration. *Id.* at 75-900.

¹⁹⁷ Of the \$8,500,000.02 purchase price, Five Smiths allocated \$50,000 to the franchise fee, \$727,086 to deferred interest payments, and \$7,722,914.02 to the veteran player contracts.

¹⁹⁸ 35 Am. Fed. Tax R. 2d at 75-905.

¹⁹⁹ *Id.* at 75-907, 75-908.

²⁰⁰ *Id.* at 75-905.

the contracts. Rather, the court assigned a value to the player contracts purchased from the NFL, concluding that \$3,035,000.00 was "the most reasonable result possible under the circumstances fully realizing that such a result may necessarily be imprecise."²⁰¹ Treasury Regulation 1.167(a)-5 authorizes this type of procedure in determining the basis for depreciation where depreciable and non-depreciable assets are acquired for a lump sum.

Laird asserted alternatively, that Five Smiths' right to share in the television revenues was a depreciable intangible asset. The contract with the NFL provided that the Atlanta franchise would participate equally with other league members in proceeds from network television contracts negotiated by the NFL "during the time the Atlanta Club continues as a member of the league." The court was on solid ground in denying this claim. Although the television contract in force at the time Atlanta entered the league spanned a definite four-year term, the franchise was entitled to share in more than this contract alone. Atlanta's right to participate in television revenue as long as the team remained in the NFL entitled it to share in network contracts which would be negotiated in the future. The useful life of this right to future television revenue was, therefore, indefinite, *i.e.*, not subject to measurement with reasonable accuracy.²⁰²

Similar treatment was afforded state liquor licenses in *Nachman v. Commissioner*.²⁰³ Although the holder of a one-year license had no legal right to renewal, the Fifth Circuit held that the useful life of the license was not subject to accurate measurement in view of established local practice which made renewal nearly automatic. Likewise, depreciable status for intangible assets has been denied in cases dealing with land leases,²⁰⁴ Federal Communications Commission television station operating licenses,²⁰⁵ and local television network affiliation contracts.²⁰⁶ In each case the useful life of the intangible asset was deemed indefinite in spite of the finite duration of the formal agreement, due to a past history of frequent renewals.

6.02 Race Horses

In accordance with Jockey Club rules, a race horse ages one year every

²⁰¹ *Id.* at 75-910. The value attributed to the player contracts by the district court was provided by Norbert Hecker, the first coach of the Atlanta Falcons, as an expert witness. The court determined that the figure represented the fair market value of the contracts and that its determination was substantiated by "persuasive evidence."

²⁰² *Id.* at 75-908.

²⁰³ 191 F.2d 934 (5th Cir. 1951).

²⁰⁴ *Shutler v. United States*, 470 F.2d 1143 (10th Cir. 1972).

²⁰⁵ *KWTV Broadcasting Co. v. Comm'r.*, 272 F.2d 406 (5th Cir. 1959).

²⁰⁶ *Comm'r. v. Indiana Broadcasting Corp.*, 350 F.2d 580 (7th Cir. 1965), *cert. denied*, 382 U.S. 1027 (1966).

January 1. In *Hardin v. Commissioner*²⁰⁷ petitioner attempted to apply the Jockey Club rule for depreciation purposes. Taxpayer acquired a race horse twenty-seven days prior to the end of the calendar year. In filing his return, petitioner depreciated the horse for one full year, claiming that the horse aged one year under the Jockey Club rule. The court disallowed the deduction for one year holding that the petitioner was permitted to depreciate the horse only for the actual period of ownership, in this case 1/12 of a year. The court based its rationale on general depreciation principles, which only entitle the taxpayer to depreciate the actual wear and tear on the asset during his period of ownership.

6.03 Economic Useful Life

Regulation 1.167(a)-3 provides that if an intangible asset has been shown, by experience, to have a limited useful life, the length of which can be estimated with reasonable accuracy, that asset may be depreciated. However, if an asset has an unlimited useful life or its useful life cannot be reasonably ascertained, no depreciation is allowed. In *Computing & Software, Inc.*,²⁰⁸ the court was asked to decide if purchased credit information files had an ascertainable useful life, thereby qualifying them for depreciation.

The petitioner purchased the credit information files from three companies. The purchase price was prorated among goodwill, furniture, fixtures, credit files, and other assets. The petitioner's claim for depreciation on the files was disallowed by the Service on the theory that the files were self-regenerative. The Service argued that when a person's name had been entered in the files, that name remained in the files, so long as customers' inquiries, which added new information about that individual, were received.

The petitioner argued that customers place great reliance on the age of the information, since an applicant who may have been a poor risk in the past may be a good risk today and, conversely, a good risk in the past may be a poor risk today. A person's ability to obtain credit is affected by employment and salary changes, credit performance, judgments, liens, bankruptcies, and other factors all of which must be updated regularly. Since its customers desire only current information, the information contained in the files will become worthless within the ascertainable future.

In rejecting the position taken by the IRS, the Tax Court noted that the petitioner regularly purged stale information from its files. Furthermore, the court found that 98 percent of the information contained in the files would be purged within six years. For these reasons, the court permitted

²⁰⁷ 35 Am. Fed. Tax R. 2d 75-460 (4th Cir. 1974).

²⁰⁸ 64 T. C. No. 20 (May 15, 1975).

the petitioner to depreciate their files on a straight-line basis, over the six-year period.

7.00 Capital Gains and Losses

7.01 Net Operating Losses

Section 269(a)(2) of the 1954 Code disallows net operating losses as an offset against later acquired income, where the corporate taxpayer's basis in the income producing property is that of its transferor, and the taxpayer made the acquisition for the principal purpose of avoiding income tax.

In *O'Mealia Reserach and Development, Inc.*,²⁰⁹ the petitioner successfully avoided the constraints of Section 269. In this case O'Mealia Research and Development, Inc., a subsidiary of O'Mealia Outdoor Advertising Corporation, was experiencing extreme financial difficulties and had incurred large net operating losses. The parent and subsidiary corporations agreed upon a plan by which the parent purchased for \$150,000 income-producing property which was directly transferred to the subsidiary. The subsidiary immediately assumed all liabilities of the parent in the transaction. In a second transaction, the parent bought 40 percent of the stock of two unrelated corporations and transferred it to the subsidiary, who again assumed all liabilities related to the transaction. The stock was later redeemed for assets which the subsidiary retained. The petitioner recorded all the liabilities and used its net operating losses to offset the acquired income on its tax return. The Commissioner disallowed the deduction under Section 269(a)(2).

Since both parties stipulated that the acquisitions of assets were part of a single plan designed to shift income-producing assets into petitioner corporation, the only disputed issue was whether the basis was determined "by reference to the basis in the hands of the transferor corporation" within the meaning of Section 269(a)(2).²¹⁰ The Commissioner argued that the purchase of assets and later transfer to petitioner by the parent corporation should be treated as separate and distinct transactions. Therefore, such stock and asset transactions would be controlled by Section 351 of the Code, requiring petitioner's basis in the acquired property to be determined by reference to that of the parent corporation.

However, by invoking the "integrated transaction" doctrine of *Yoc Heating Corp.*,²¹¹ the Tax Court held that the purchase of the assets constituted a single transaction. The court reasoned that the parent

²⁰⁹ 64 T. C. No. 47 (June 26, 1975).

²¹⁰ *Id.* at 275.

²¹¹ 61 T. C. 101 (1973).

corporation had acted as a conduit through which the assets passed; therefore, the petitioner's basis was determined by reference to the cost of the assets to the petitioner, and not by reference to the basis of the assets in the hands of the parent corporation. Since the basis of the acquired assets was a cost basis, as opposed to carryover basis, Section 269(a)(2) was inapplicable, and the court therefore permitted the net operating loss deduction to offset the later income.

7.02 "Like-Kind" Property

Section 1031(a) of the Internal Revenue Code allows a taxpayer to exchange property for other property of a like kind without recognizing gain or loss, if the property transferred was held for productive use in the transferor's trade or business and the property received is also to be so used. Although most of Section 1031 cases deal with what constitutes "like-kind" property, two recent Revenue Rulings highlighted the Section's requirement that both the property traded away and the property received must be productively used by the taxpayer.

In Revenue Ruling 75-921,²¹² Corporation A desired a tract of land and factory owned by Corporation B. To this end, the former purchased another tract and constructed a factory upon it. Corporation A then exchanged this newly-acquired land and factory for the land and factory owned by Corporation B. The IRS ruled that only Corporation B was entitled to Section 1031(a) non-recognition of gain or loss, since the property Corporation A had transferred had not been held for productive use in A's trade or business.

In Revenue Ruling 75-292,²¹³ Section 1031(a) treatment was denied Corporation C when it exchanged land and office buildings productively used in its business for similar land and office buildings owned by Corporation D. Difficulties arose when Corporation C transferred its newly acquired property to a third corporation, formed by it, in exchange for all of the stock of the new corporation. Since the final result of the transaction was that C ended up with a fluid corporation's stock rather than like-kind property, which it could put to productive use, only D Corporation was able to qualify for Section 1031 treatment.

7.03 Corporate Stock Held by Corporate Officer

Revenue Ruling 75-13²¹⁴ provides a response to the question of whether an officer-stockholder of a stock brokerage and investment firm, who purchased stock in the corporation which later becomes worthless, can

²¹² Rev. Rul. 75-291, 1975 INT. REV. BULL. No. 29, at 17.

²¹³ Rev. Rul. 75-292, 1975 INT. REV. BULL. No. 29, at 18.

²¹⁴ Rev. Rul. 75-13, 1975 INT. REV. BULL. No. 2, at 6.

receive ordinary loss rather than capital loss tax treatment. Here, an individual began his employment with an incorporated stock brokerage and investment banking firm in 1960. From 1962, when the employee became an officer, to 1968, the firm experienced remarkable growth and high prosperity. Beginning in 1968 the firm suffered severe financial setbacks resulting in cessation of all normal business operations and the initiation of liquidation in 1970. Before 1962 and up to December 1967, the taxpayer at various times purchased shares of stock in the employer corporation. Some of the stock purchases were made after taxpayer had received promotions. Purchase of the stock was not mandatory; however, the corporation did encourage such purchases and employees considered such purchases of stock helpful in obtaining promotions within the firm.

In 1968, the taxpayer, when he was in a position to know the full extent of the firm's difficulties, ceased purchasing stock. Despite his lack of stock purchases in 1968 to 1970, taxpayer received two significant promotions during the same period. In 1970, taxpayer's stock became worthless. The taxpayer argued that the purchase of stock was a condition of employment and promotion, and that being an integral part of his business, the resulting loss should be treated as ordinary loss under Section 165 of the Code.

The Commissioner in this ruling adopted the test applied by the Supreme Court in *Corn Products Refining Co. v. Commissioner*,²¹⁵ which held that profits and losses arising from the everyday operation of a business should be considered as ordinary income or loss rather than capital gain or loss. Later court decisions have indicated that the question of whether the sale or exchange of stock results in ordinary, as opposed to capital gain or loss is dependent upon whether the taxpayer acquired the stock with a "predominant business" motive as distinguished from a predominant investment motive.²¹⁶

In the instant set of circumstances, the purchase of stock was held not to be a condition of employment or promotion. The taxpayer's stock purchases were all within the period of the firm's rapid growth and high prosperity, making the purchase of such stock an attractive investment. When the firm faltered, the taxpayer ceased his purchase of stock. Even though he ceased purchasing stock, he received two promotions. It was quite apparent that the taxpayer purchased the stock for investment purposes and that such

²¹⁵ 350 U.S. 46 (1955).

²¹⁶ Rev. Rul. 75-13, 1975 INT. REV. BULL. No. 2, at 7. Motive is determined by analyzing all the surrounding circumstances. See *United States v. Geneser*, 405 U.S. 93 (1972).

purchases were not necessary to maintain employment or receive promotions. Therefore, the taxpayer sustained a capital loss in the year the corporate stock became worthless.

*Irwin v. United States*²¹⁷ recently held that an attorney, who purchased stock in a corporation to enhance and increase the amount of legal business he would derive from the corporation, will be entitled to an ordinary business deduction when that stock becomes worthless. In order to determine whether the stock fell within the "integrated business activities exception" to the definition of a capital asset, as established by the *Corn Products* case, the district court adopted²¹⁸ the test originally articulated in *Booth Newspapers, Inc. v. United States*.²¹⁹

[I]f securities are purchased by a taxpayer as an integral and necessary act in the conduct of his business, and continue to be so held until the time of their sale, any loss incurred as a result thereof may be fully deducted from gross income as a business expense or ordinary loss.²²⁰

It is clear that if the property is held for investment purposes, final disposition will result in capital asset treatment. In the instant case petitioner's purpose for purchasing stock was to acquire the legal and notarial business of the corporation. The district court examined petitioner's past and present stockholdings, his position within the corporate structure (director and later president), and his initial and subsequent involvements in the corporation, and determined that he had truly purchased the shares in expectation of increasing his legal business. He was, therefore, entitled to a deduction from gross income as a business expense or ordinary loss.

7.04 Forfeited Deposits

Revenue Ruling 58-77,²²¹ which held that any gain or loss realized or sustained, due to the failure of customers to return containers, for which deposits are required, within a specified period is to be treated as ordinary gain or loss, has been revoked by Revenue Ruling 75-34.²²² This ruling provides that, if Corporation A manufactures cable which is sold on steel reels, having a useful life of eight years, and requires a refundable deposit

²¹⁷ 36 Am. Fed. Tax R. 2d 75-5073 (E. D. La. May 22, 1975).

²¹⁸ *Id.* at 75-703. The district court in *Irwin* erroneously attributed the test it applied to the Fifth Circuit's opinion in *Schlumberger Technology Corp. v. United States*, 443 F.2d 1115 (5th Cir. 1971). However, the *Schlumberger* court merely adopted the test as it was originally set forth in the *Booth Newspapers* case, 443 F.2d at 1120.

²¹⁹ 303 F.2d 916 (Ct. Cl. 1962).

²²⁰ *Id.* at 921.

²²¹ Rev. Rul. 58-77, 1958-1 CUM. BULL. 118.

²²² Rev. Rul. 75-34, 1975 INT. REV. BULL. No. 5, at 14.

from its customers, or if title in the cable reels passes to the customer by contract, with the corporation retaining the deposit, the reels will qualify under Section 1231(b) of the Code as depreciable property used in the taxpayer's trade or business. The gain or loss from the sale of the cable reels then be treated under Section 1231(a) of the 1954 Code.

In order to benefit from the favorable business tax treatment of Section 1231 which allows gain to be treated as capital gain and loss to be treated as ordinary loss, Corporation A must capitalize its cost of the reels and maintain adequate records reflecting depreciation and other factors necessary in the computation of gain or loss on the sale of the reels.

Revenue Ruling 75-34 is consistent with the decision by the Court of Claims in *Philadelphia Quartz Co. v. United States*.²²³ The court held that where a taxpayer transported chemical products in returnable steel drums, bearing legends indicating that the taxpayer owned the drums and separately billed buyers for the drums, at prices significantly higher than their cost, the income, resulting from such forfeiture of deposits, was to be treated as a capital gain from the sale or exchange of business assets, under Section 1231 of the Code.

8.00 Procedure

8.01 Tax Exempt Status—Private Schools

In Technical Information Release 1347,²²⁴ the Internal Revenue Service announced a Proposed Revenue Procedure concerning tax exempt status for private schools under Section 501(c)(3). The proposed procedure would require all private schools desiring Section 501(c)(3) tax exempt status (whether presently tax exempt or applying for such status) to keep specified records and to meet specific anti-discrimination guidelines. The record keeping requirements and guidelines have been drawn to determine whether private schools, having or seeking tax exempt status, racially discriminate against students.²²⁵

The Proposed Revenue Procedure was prompted by a need for a new system to "ensure a uniform approach"²²⁶ in determining whether such private

²²³ 374 F.2d 512 (Ct. Cl. 1967).

²²⁴ T. I. R. 1347, 6 P-H 1975 FED. TAXES ¶ 55,050.

²²⁵ A racially nondiscriminatory policy as to students is defined to mean that:

. . . the school admits the students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs. Rev. Rul. 71-447, 1972-2 CUM. BULL. 230.

²²⁶ T. I. R. 1347 § 2.03, 6 P-H 1975 FED. TAXES ¶ 55,050.

schools have been following a nondiscriminatory policy as to students. Failure to comply with the proposed record keeping requirements will result in a presumption that the school has failed to comply with the guidelines.²²⁷ Failure to comply with the guidelines, themselves, will ordinarily result in the revocation of the tax exempt status of the noncomplying school.²²⁸

Revenue Procedure 72-54²²⁹ sets forth the presently effective guidelines for determining whether a school has sufficiently publicized its nondiscriminatory policies. Under the present procedure, a school is required to show only that a nondiscriminatory policy has been adopted, is being used in good faith, and has been made known to the community from which the school draws its students.

The proposed procedure under Technical Information Release 1347 reflects the dissatisfaction of the Internal Revenue Service with the present guidelines under Revenue Procedure 72-54.²³⁰ The proposed procedure provides guidelines as to organization requirements,²³¹ publication requirements,²³² annual notification and certification,²³³ facilities and programs,²³⁴ and scholarships and loan programs.²³⁵

If adopted, the guidelines will impose as an organizational requirement that a school provide in its "charter, bylaws, resolution of its governing body, or other governing instrument that it will not discriminate against applicants and students on the basis of race."²³⁶

With regard to the proposed publication guidelines, any method may be used to publicize the school's nondiscriminatory policy, as long as it is effective in reaching all racial segments of the community which may use the school.²³⁷ Under this procedure the school also will be required to publicize its nondiscriminatory policy at least once a year, either during student registration or during the school's solicitation of students. The proposed guidelines also require the school to certify that it has not qualified any of its previous published statements.²³⁸

²²⁷ *Id.* § 6.02, 6 P-H 1975 FED. TAXES ¶55,050. The presumption may be rebutted only through use of clear and convincing evidence.

²²⁸ *Id.* § 3.06, 6 P-H 1975 FED. TAXES ¶ 55,050.

²²⁹ Rev. Proc. 72-54, 1972-2 CUM. BULL. 834.

²³⁰ T. I. R. 1347 § 2.03, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³¹ *Id.* § 3.01, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³² *Id.* § 3.02, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³³ *Id.* § 3.03, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³⁴ *Id.* § 3.04, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³⁵ *Id.* § 3.05, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³⁶ *Id.* § 3.01, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³⁷ *Id.* § 3.02, 6 P-H 1975 FED. TAXES ¶ 55,050.

²³⁸ *Id.* § 3.03, 6 P-H 1975 FED. TAXES ¶ 55,050.

The proposed recordkeeping requirements state that each school must keep the following records for a period of three years:

- (1) All applications for general admissions. Any rejected applications must be annotated to show the reasons for rejection.
- (2) All requests for scholarships or other forms of financial aid, and a list of the amounts awarded or the reasons for rejection, together with copies of all correspondence concerning comparable requests to other parties insofar as the school has at any time been a party to such correspondence.
- (3) All applications for employment. Any rejected applications must be annotated to show the reasons for rejection.
- (4) Copies of all catalogues brochures, announcements, and other printed advertising.
- (5) Copies of all materials used to solicit contributions, and all contributions received.²³⁹

The proposed procedure is much stricter than the present requirements of Revenue Procedure 72-54.

8.02 Tax Exempt Status—Private Clubs

Under Section 501(c)(7) a social club will qualify for a tax exempt status if the club is "organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual." In *Pittsburgh Press Club v. United States*,²⁴⁰ the Federal District Court for the Western District of Pennsylvania considered the issues of when a club's purpose fails to be nonprofitable and when a private individual benefits from the club's earnings.

The Internal Revenue Service revoked the tax exempt status of the Pittsburgh Press Club, contending that the club failed to meet the requirements of Section 501(c)(7). The Service argued that the revocation was justified on two grounds: first, that club earnings inured to the benefit of private individuals through the club's differential dues structure favoring a particular class of members; and, secondly, that the club was not operated exclusively for nonprofitable purposes—due to the substantial number of nonmembers patronizing the facility.²⁴¹

The press club employed a dues structure under which members involved in editorial work (called active members) paid lower dues than

²³⁹ *Id.* § 6.01, 6 P-H 1975 FED. TAXES ¶ 55,050.

²⁴⁰ 388 F. Supp. 1269 (W. D. Pa. 1975).

²⁴¹ *Id.* at 1272.

those not directly involved in such work. Active members enjoyed other singular privileges including the sole right to vote and the sole right to serve as club officers or directors with the exception of the position of Treasurer.

The district court held that the dues structure did not result in net earnings to active members. Instead, the court found that the club policy was designed simply to reflect ability to pay and that the policy was not a burden on other members.²⁴² The court relied on the reasoning employed by the Supreme Court in the decision of *Walz v. Commissioner*²⁴³ to support its result. In *Walz*, the Supreme Court held that a church which is exempted from paying property tax does not receive revenue from the government, and therefore, the exemption provided does not amount to a prohibited establishment of religion. The church is simply exempted from making payments to support the state. Here, the active members of the club do not receive earnings but are exempted to a limited extent from the obligation to pay club dues.²⁴⁴

The Court next considered the contention that the club failed to meet the statutory requirement of operating exclusively for nonprofitable purposes. Although the club was not open to the general public, it served a substantial number of meals to nonmembers. Under club rules, nonmembers could be served when they were a guest of a member or a part of a group sponsored by a member.

The Service contended that the nonmember use of club facilities required revocation of the 501(c)(7) exemption, first, because the charges for services provided nonmembers were ultimately paid by the nonmembers themselves and, secondly, because the club failed to meet the 75 percent rule of Revenue Procedure 64-36.²⁴⁵ The Service argued that nonmember guests traditionally reimburse their hosts for charges incurred for services provided them. The club failed to meet the Revenue Procedure 64-36 requirement that at least 75 percent or more of the club members be members of the nonmember groups using club facilities.²⁴⁶

The district court reinstated the club's exemption. Although the court agreed that guests traditionally reimburse host members for club services received by them, it found such a practice to be customary in the member-

²⁴² *Id.* at 1273.

²⁴³ 397 U.S. 664 (1970).

²⁴⁴ 388 F. Supp. at 1274.

²⁴⁵ Rev. Proc. 64-36, 1964-2 CUM. BULL. 962.

²⁴⁶ 388 F. Supp. at 1275.

guest relationship and within the 501(c)(7) exemption. The court also found Revenue Ruling 64-36 "not controlling", and refused to apply its requirements to the instant case.²⁴⁷

The decision by the court will be useful for clubs who charge different dues rates to their members. They will no longer have to worry about losing their tax exempt status under this decision, since differential dues structures such as that employed by the Pittsburgh Press Club do not result in net earnings to regular members. Finally, as long as the club is not open to the general public, nonmember use of club facilities by guests of members will not cause a club to lose its tax exempt status.

8.03 Tax Exempt Status—Unrelated Business Activities

A trade association composed of travel agencies failed in its attack on the tax exempt status of otherwise exempt organizations which offer extensive low-cost travel plans for their members.²⁴⁸ The American Society of Travel Agents alleged that since travel is not an exempted organizational purpose within Section 501(c)(3), the tax exempt status of groups engaging in massive travel programs for members should be revoked. The Federal District Court for the Northern District of California declined to order revocation of exempt status, holding that such relief would be appropriate only after a finding that the travel plans were *per se* unrelated to the organization's tax exempt purposes.

The court likewise declined to order the IRS to levy the "unrelated business tax" on the income received by the organizations, from travel programs. In reaching its decision, the court said:

The court's jurisdiction may be invoked to check a specific abuse of discretion by IRS But it may not be invoked to undertake continuing supervision of IRS's administration of the Internal Revenue Code. Plaintiff's second count fails to state a claim upon which relief can be granted.²⁴⁹

8.04 Tax Exempt Status—Public Interest Law Firm

In Revenue Ruling 75-74,²⁵⁰ the Internal Revenue Service defined the "ideal" type of public interest law firm which qualifies for an exemption under Section 501(c)(3) of the Code. The "ideal" organization should have a board of governors whose membership would consist of a majority of

²⁴⁷ *Id.* at 1277.

²⁴⁸ *American Society of Travel Agents v. Simon*, 36 AM. FED. TAX R. 2d 75-5142 (D. D. C. 1975).

²⁴⁹ *Id.* at 75-5144.

²⁵⁰ *Rev. Rul. 75-74*, 1975 INT. REV. BULL. No. 10, at 7.

attorneys and include law professors and leaders of public interest organizations. The criteria established for an acceptable case is as follows: (1) the subject matter must involve a matter of important public interest; (2) the prospective clients must not be able to afford competent private legal counsel; and (3) the case should provide for active participation by law students.

The tax exempt public law firm is to be operated exclusively for charitable purposes. Charitability is to be based, not upon the particular positions advocated by the firm, but upon providing a vehicle for the resolution of issues of broad public importance and the inability of the prospective clients to afford adequate private counsel. The fact that the services provided by the public interest law firm are not feasibly handled by private firms may, also, be a prerequisite of charitable recognition.

In order to maintain its exemption, the public law firm may not charge for its services, even on a cost basis.²⁵¹ However, under Revenue Ruling 75-76,²⁵² the firm can accept court-awarded fees, which the opposing party must pay under statute, and certain special fees which the judge orders to be paid. The exempt public firm must use such awards only to defray normal operating expenses up to a limit of 50 percent of the total cost of its legal functions. The percentage is to be computed over a five-year period, which includes the taxable year the fee is awarded and the four preceding tax years. The thrust of these recent Revenue Rulings is to prohibit a tax exempt public law firm from using, as a factor in selecting its cases, either the expectation or the possibility of an award of attorney fees.²⁵³

Revenue Ruling 75-74 also requires all public interest law firms to file form 1023²⁵⁴ with the District Director of the IRS in the district in which the principle place of business or principle office of the firm is located. Compliance with this requirement is necessary to be eligible for tax exempt status under Section 501(c)(3) of the Code.

8.05 Self-Incrimination

An individual may not refuse to file a federal income tax return on the basis that some information contained therein is self-incriminating; he may, however, refuse to answer certain questions on the return where the response may tend to incriminate him.²⁵⁵ The question which arises is whether

²⁵¹ Rev. Rul. 75-75, 1975 INT. REV. BULL. No. 10, at 9.

²⁵² Rev. Rul. 75-76, 1975 INT. REV. BULL. No. 10, at 9.

²⁵³ *Id.* at 10.

²⁵⁴ Rev. Rul. 75-74, 1975 INT. REV. BULL. No. 10, at 8.

²⁵⁵ *United States v. Sullivan*, 274 U.S. 259 (1927).

or not a response to such a question on the tax return, may be used as evidence against the taxpayer in a criminal trial unrelated to the tax laws. Certiorari has been granted by the Supreme Court to a Ninth Circuit case for the determination of this question.²⁵⁶

In *Garner v. United States*,²⁵⁷ the taxpayer filed a federal income tax return, and revealed that gambling was the principle source of his income. The tax return was used as evidence against Garner in a subsequent prosecution for conspiring to violate federal gambling statutes. Garner contended that the government's use of the tax return violated his fifth amendment privilege against self-incrimination, and the Ninth Circuit agreed. The majority held that in spite of Garner's right to object to revealing his source of income, his disclosure was not voluntary in light of the reporting requirements contained in Section 7203 and Section 7206.

In reaching its conclusion the court overruled its prior decision in *Stillman v. United States*²⁵⁸ (holding that tax returns are admissible as evidence in an unrelated criminal prosecution despite fifth amendment claims on the basis of implied waiver), relying on the Supreme Court's refusal to apply the implied waiver concept in *Marchetti v. United States*.²⁵⁹ *Marchetti*, however, involved a statute requiring special registration, which was potentially incriminating and, as the dissenting judge in *Garner* indicates,²⁶⁰ the majority's extension of *Marchetti* to a case involving routine filing may be a fundamental weakness in the court's reasoning.

Another issue which the courts addressed this year was whether a taxpayer could, through the assertion of his fifth amendment privilege against self-incrimination, thwart an IRS investigation by obtaining his accountant's working papers and subsequently transferring them to his attorney. In *Fisher v. United States*²⁶¹ and *Kasmir v. United States*,²⁶² the courts of appeals for the Third and Fifth Circuits, disagreed as to the answer to this question. The Supreme Court has recently granted certiorari²⁶³ in an attempt to resolve this "hotly contested issue."²⁶⁴

²⁵⁶ *Garner v. United States*, 501 F.2d 228, (9th Cir. 1972), cert. granted, 95 S. Ct. 1115 (1975).

²⁵⁷ 501 F.2d 228 (9th Cir. 1972).

²⁵⁸ 177 F.2d 607 (9th Cir. 1949).

²⁵⁹ 390 U.S. 39 (1968).

²⁶⁰ 501 F.2d at 235 (Wallace J., dissenting).

²⁶¹ 500 F.2d 683 (3rd Cir. 1974).

²⁶² 499 F.2d 444 (5th Cir. 1974).

²⁶³ 500 F.2d 683 (3rd Cir. 1974), cert. granted, 95 S. Ct. 824 (1975) (Upon granting certiorari the Supreme Court consolidated the *Fisher* and *Kasmir* cases.).

²⁶⁴ 499 F.2d at 448.

Attempting to delineate the point at which the important IRS power of summons²⁶⁵ and enforcement²⁶⁶ in tax investigations must yield to the guarantees of the fifth amendment²⁶⁷ is a sensitive and difficult task. Generally viewed as preventing the compulsion of testimonial self-incrimination, the protection of the fifth amendment has been applied to incriminating business records and memorandum since the landmark decision in *Boyd v. United States*.²⁶⁸ Even though barring sources of evidence is unfavorable to the efforts of any government agency, applying the fifth amendment protection to private business and tax records is an especially serious hindrance to the IRS, since it must rely on voluntary assessment and compliance by taxpayers. Furthermore, it is exceedingly difficult to ascertain a taxpayer's tax liability from the external evidentiary sources which are normally relied upon in non-tax prosecutions. Indeed, it is arguable that if taxpayers were cognizant of the protection from discovery of tax evasion offered by the fifth amendment as applied to business records, the voluntary compliance basis of our tax system would be shattered.

As stated, the basis for the taxpayer's assertion of a fifth amendment protection is the *Boyd* decision. In *Boyd*, it must be emphasized that the taxpayer had both title and possession of his receipts; therefore, when the court spoke of private and personal business records, it was not clear whether the court considered title or possession most important. The *Boyd* rationale was explicitly extended to tax records in *United States v. Cohen*.²⁶⁹

Fisher and *Kasmir* differed from *Boyd* in that the title of the business memorandum was held by the accountant. Additionally, both taxpayers had obtained possession only a relatively short time before the summons was served. In *Fisher*, the taxpayer's accountant had possession of his working papers for twelve years before the taxpayer re-acquired possession of them. After holding the papers for two weeks, the taxpayer transferred them to his attorney who was subsequently served with the summons two and one-half months later. In *Kasmir* the facts are similar; when he became aware of the IRS investigation, the taxpayer asked his attorney and accountant to meet him at his office. Taking the papers from his accountant, the taxpayer immediately transferred them to his attorney. The taxpayer had actual possession of these papers for only a few seconds.

In *Couch v. United States*,²⁷⁰ the Supreme Court dealt with a situation

²⁶⁵ INT. REV. CODE OF 1954, § 7602.

²⁶⁶ INT. REV. CODE OF 1954, § 7604.

²⁶⁷ U.S. CONT. amend. V.

²⁶⁸ 116 U.S. 616 (1886).

²⁶⁹ 388 F.2d 464 (9th Cir. 1967).

²⁷⁰ 409 U.S. 322 (1973).

where business records owned by the taxpayer, but in the accountant's possession, were summoned by the IRS. The *Couch* Court held that in applying fifth amendment protections, the emphasis is upon avoidance of personal compulsion. The Court then stated: "We do indeed believe that actual possession of documents bears the most significant relationship to fifth amendment protections against governmental compulsions upon the individual accused of crime."²⁷¹ By establishing that possession rather than title was the major factor in determining the validity of the self-incrimination assertion, the stage was set for taxpayers to assert the privilege as to their accountant's working papers which they possessed but did not own. However, even in situations such as *Kasmir* and *Fisher*, where the taxpayer did not have actual possession at the time of summons, *Couch* again opened a door for taxpayers through the following dictum:

[S]ituations may well arise where constructive possession is so clear or the relinquishment of possession is so temporary and insignificant as to leave the personal compulsions upon the accused substantially intact.²⁷²

In *Couch*, the taxpayer did not have actual possession of the records until after the summons was served on his accountant. The Court held that the rights of the taxpayer were frozen at the time the summons had been served.²⁷³ In *United States v. White*,²⁷⁴ the taxpayer's accountant transferred his working papers to the taxpayer's attorney a year before the summons was served. However, in that case, the taxpayer never had actual possession of the working papers, nor is it clear that he even had knowledge of the transfer. Since there was no actual possession, the court once again held there was no privilege.

The question in *Fisher* and *Kasmir* was the narrow one of whether by taking possession of his "hot" papers for two weeks or two seconds before transferring them to his attorney, the taxpayer can avail himself of the fifth amendment privilege. The threshold question that both circuit courts addressed themselves to was whether the taxpayer could have claimed fifth amendment protection if the summons had been served the instant in which he physically held the papers.²⁷⁵ The *Fisher* court inappropriately borrowed

²⁷¹ *Id.* at 333.

²⁷² *Id.*

²⁷³ *Id.* at 329.

²⁷⁴ 487 F.2d 1335 (5th Cir. 1973).

²⁷⁵ *Fisher v. United States*, 500 F.2d at 689 (3rd Cir. 1974); *Kasmir v. United States*, 499 F.2d at 447 (5th Cir. 1974).

a phrase from the *Couch* decision²⁷⁶ and stated that the shift to the taxpayer presents a "temporary and insignificant history of actual possession in the taxpayer"²⁷⁷ Thus, the *Fisher* court seemed to determine the question on the basis of the duration and purpose of actual possession by the taxpayer. Without the taxpayer having a right to assert the privilege, the court did not find it necessary to come to grips with the issue of whether or not the papers in the attorney's possession were constructively possessed, stating: "Papers otherwise not endowed with fifth amendment protection cannot be transmuted into a privileged status merely because of the act of delivery to a lawyer."²⁷⁸ The *Kasmir* court²⁷⁹ and Judge Hunter's partial dissent in *Fisher*²⁸⁰ declared that the duration of actual possession was irrelevant. Judge Hunter argued: "I fail to understand how the personal compulsion, which is the essence of the fifth amendment prohibition, can vary depending on the length of time the documents had previously been in Goldsmith's (taxpayer) actual possession."²⁸¹

The logic of the *Kasmir* court seemed particularly appropriate. The Fifth Circuit rationalized that if, as *Couch* had declared,²⁸² the rights of the parties were frozen at the time of the summons, the taxpayer could assert the privilege if he actually possessed the records, regardless of when he had acquired them. If this "freezing" theory was valid, the *Kasmir* court concluded that to diminish the taxpayer's rights, for transferring the papers to his attorney, was *a fortiori* inappropriate. Due to the traditional expectations of confidentiality accompanying the attorney-client relationship, the court believed that the taxpayer should be deemed to have maintained constructive possession permitting him to assert the fifth amendment privilege.²⁸³ The *Kasmir* court distinguished the attorney-client relationship from the accountant-client relationship in *Couch*. *Kasmir* stated that in *Couch*, the records were given to the accountant for the purpose of tax return preparation; the taxpayer must have realized that the accountant was under a duty

²⁷⁶ 409 U.S. at 333.

²⁷⁷ 500 F.2d at 691.

²⁷⁸ *Id.*

²⁷⁹ 499 F.2d 444.

²⁸⁰ 500 F.2d at 691.

²⁸¹ *Id.* at 695.

²⁸² 409 U.S. at 329 n. 9.

²⁸³ 499 F.2d at 453-54, where the court stated:

Nor has the government offered any reason why we should compel the taxpayer to hold onto the documents for a particular period of time. In our judgment, the taxpayer's short-lived possession was sufficient to permit a claim based on the Self-Incrimination Privilege, and the subsequent transfer to his attorney evidenced a sufficient legitimate expectation of privacy to permit the taxpayer to retain the Amendment's protection through constructive possession.

to disclose the basis of his computations.²⁸⁴ However, in *Kasmir*, the working papers were given to the attorney for legal advice and preparation for a possible suit. Additionally, *Kasmir* stated that the taxpayer legitimately expected greater privacy and confidentiality in transactions with his attorney.²⁸⁵

Unfortunately, neither *Couch*, *Fisher*, nor *Kasmir* dealt with the validity of the "required records" doctrine which was enunciated in *Shapiro v. United States*.²⁸⁶ This concept contends that if the government requires the preparation and maintenance of records in regards to any activity validly controlled by the government, then the records cannot be privileged.

Perhaps the judges dismissed the "required records" doctrine because of its potential for misuse. However, it seems that if the *Fisher* viewpoint should prevail, it should do so on this basis rather than any technical argument based on duration of actual possession.

8.06 Criminal Procedure in Tax Proceedings

Evidence seized from a defendant, during a search pursuant to a warrant issued without probable cause, is inadmissible in a criminal prosecution of the defendant.²⁸⁷ The issue arises as to whether the IRS may use such unlawfully seized evidence as the basis for a civil tax assessment. The question was answered in the negative in *Janis v. United States*.²⁸⁸ The Supreme Court, however, will review that decision.²⁸⁹

In *Janis*, the Los Angeles Police Department seized bookmaking paraphernalia and cash from the defendants' premises under a defective warrant. The cash was seized by the IRS, after it assessed an excise tax deficiency against Janis for his bookmaking operations. The court ordered that the cash be returned to Janis, and held the excise tax assessment invalid since substantially all the evidence underlying the assessment was obtained by the IRS through the illegal actions of the police officers who conducted the search. The Supreme Court decision, hopefully, will clarify this extension of the exclusionary rule to the civil tax area.

In *United States v. Beckwith*,²⁹⁰ the District Court for the District of Columbia held that a Miranda warning is not required where IRS agents

²⁸⁴ *Id.* at 452.

²⁸⁵ *Id.* at 453.

²⁸⁶ 335 U.S. 1 (1948).

²⁸⁷ *Spinelli v. United States*, 393 U.S. 410 (1969).

²⁸⁸ 31 Am. Fed. Tax R. 2d 73-1049 (C. D. Cal. 1973).

²⁸⁹ 31 AM. FED. TAX R. 2d 73-1049 (C. D. Cal. 1973), *cert. granted*, 421 U.S. 1010 (1975).

²⁹⁰ 510 F.2d 741 (D. C. Cir. 1975):

question a taxpayer in a friend's home, since such interrogation is non-custodial. The agents questioned defendant while at the home of a friend, without fully apprising him of his rights. The information obtained from the questioning was used to convict Beckwith of tax evasion. The defendant contended that the full Miranda warning was required prior to interrogation, and argued that *Mathis v. United States*,²⁹¹ and *United States v. Dickerson*²⁹² were controlling under the circumstances. The court rejected defendant's contentions, however, on the basis that both cases were distinguishable.

In *Mathis*, interrogation of the taxpayer by IRS agents while he was incarcerated in a state prison was clearly custodial, whereas the suspect in the instant case was free to leave the home at any time. In *Dickerson*, no warning of any kind had been given to the suspect, whereas Beckwith was given a "modified" Miranda warning.²⁹³ The fact that Beckwith was substantially apprised of his rights, however, may limit the application of this case in the future to situations where such a modified warning is given.

8.07 Freedom of Information Act

On July 4, 1966 President Lyndon B. Johnson signed into law the Freedom of Information Act.²⁹⁴ The purpose of this Act was: (1) to make available to "any person" vast amounts of government records; (2) to specify nine classes of records exempt from the provisions of the Act; and (3) to establish a system of judicial review for persons denied records under the Act with the burden of proof placed on the agency to justify its withholding.²⁹⁵

Section 552(a)(2) of the Act makes available for public inspection and copying, statements of policy and interpretations adopted by an agency, but not published in the Federal Register, administrative staff manuals, and instructions that affect a member of the public.²⁹⁶ Section 552(b) exempts from the provisions of the Act nine specific classes of information, the most important of which for purposes of tax litigation are paragraphs (b)(2), (3), (4), and (5).²⁹⁷

Judicial interpretation of these provisions has been made somewhat

²⁹¹ 391 U.S. 1 (1968).

²⁹² 413 F.2d 1111 (7th Cir. 1969).

²⁹³ 510 F.2d at 742 n. 6.

²⁹⁴ Freedom of Information Act, 5 U.S.C. § 552 (1967) (hereinafter referred to as the Act or the FOIA).

²⁹⁵ Kass, *The New Freedom of Information Act*, 53 A.B.A.J. 667 (1967).

²⁹⁶ Freedom of Information Act, 5 U.S.C. § 552(a)(2) (1967).

²⁹⁷ Freedom of Information Act, 5 U.S.C. § 552(b) (1967).

difficult due to differences between the House Report²⁹⁸ and the Senate Report.²⁹⁹ The courts have generally preferred the Senate Report's version over the House version for two reasons. First, the Senate Report generally follows the express language of the statute;³⁰⁰ second, the Senate Report was before both Houses when the Act was adopted.³⁰¹ A discussion of the applicable cases aptly reveals this preference.

In *Tax Analysts and Advocates v. Internal Revenue Service*,³⁰² plaintiff sought to compel the IRS to disclose three items: first, unpublished private letter rulings and technical advice memoranda issued to producers of minerals, other than oil and gas; second, communications to and from the IRS with regard to said rulings and memoranda, from outside the Executive Branch of the United States Government; third, all the necessary material from the IRS letter ruling index system in order to permit plaintiff to ascertain whether additional unpublished rulings existed. In the district court the IRS contended that Section 552(a)(2)(b) of the Act did not apply to letter rulings or technical advice memoranda, and that even if the Act did apply, specific exemptions precluded disclosure of the materials sought. The district court, in deciding whether Section 552(a)(2)(b) relating to "statements of policy and interpretations which have been adopted by the agency" applied to private letter rulings and technical advice memoranda, compared the Senate Report to the House Report.³⁰³ However, the court concluded that the Senate Report was to be preferred for the reasons mentioned above.³⁰⁴ Furthermore, the court came to the conclusion that letter rulings and technical advice memoranda were in fact "relied upon" by the agency as at least a "research tool."³⁰⁵

The IRS argued in the alternative that even if the Act did apply, paragraphs (b)(3) and (4) regarding trade secrets, confidential information, and matters specifically exempted from disclosure by statute acted to prevent such disclosures. The court cited *National Cable Television Association, Inc. v. F.C.C.*³⁰⁶ which held that paragraph (b)(4) protects "only that information which cannot be rendered sufficiently anonymous by deletion of the filing

²⁹⁸ H. R. REP. NO. 1497, 89th Cong. 2nd. Sess. 2418 (1966) (hereinafter cited as H. REP.).

²⁹⁹ S. REP. NO. 813, 89th Cong. 1st Sess. 2418 (1965) (hereinafter cited as S. REP.).

³⁰⁰ *Hawkes v. IRS*, 467 F.2d 787 (6th Cir. 1972).

³⁰¹ Comment, *Response of the IRS to the Freedom of Information Act: An Uphill Battle for Disclosure*, 1974 ARIZ. ST. L. J. 431.

³⁰² 362 F. Supp. 1298 (D. D. C. 1973).

³⁰³ *Id.* at 1304.

³⁰⁴ See text accompanying notes 283 and 284 *supra*.

³⁰⁵ 362 F. Supp. 1298, 1306 (D. D. C. 1973).

³⁰⁶ 479 F.2d 183 (D. C. Cir. 1973).

party's name and other identifying information." The IRS argued that since Section 6103(a)(1) provides that returns will be open to inspection only by order of the President, then paragraph (b)(3) is applicable. The court concluded that a voluntary request from a taxpayer submitting information and seeking tax guidance for his own purpose is not a return within the meaning of the statute.³⁰⁷

Finally, the IRS contended that the court should use its inherent powers of equity to refuse disclosure, since such disclosure would result in the disruption of the agency's established procedures and possibly cause the present program of private letter rulings to cease. The court replied that it had no discretion since the disputed materials came within the terms of the statute.³⁰⁸ The district court concluded its opinion by observing that while the private letter rulings were widely disseminated among the tax bar and taxpayers with similar problems and interests, resulting in a body of "private law", publication would allow total public access and scrutiny.³⁰⁹

On appeal,³¹⁰ the IRS limited its arguments to whether the (b)(3) exemption for matters specifically exempted from disclosure by statute was applicable, and whether the district court had erred in holding that under the Act it did not have the equitable power to refuse ordering disclosure. The court of appeals held that private letter rulings were not encompassed by either Section 6103(a)(1), restricting disclosure to orders of a President, or Section 7213(a)(1), making it unlawful for any person to divulge to any other person, portions of income tax returns.³¹¹ However, the appellate court decided that technical advice memoranda dealt directly with information contained in returns, were a part of the process by which tax determinations were made, and were specifically exempted from disclosure by statute under the meaning of paragraph (b)(3). Without discussing the issue, the court affirmed the decision of the district court holding that it had no jurisdiction under the Act to deny disclosure on equitable grounds.³¹²

In *Hawkes v. Internal Revenue Service*,³¹³ plaintiff sought items, including portions of the Internal Revenue Manual relating to the examination of returns and interrogation of taxpayers by agents of the Service, and other matters which plaintiff felt would be useful in preparing his defense to an indictment for criminal tax fraud in a separate proceeding. After having

³⁰⁷ 362 F. Supp. 1298, 1308 (D.D.C. 1973).

³⁰⁸ *Id.* at 1309.

³⁰⁹ *Id.*

³¹⁰ 505 F.2d 350 (D. C. Cir. 1974).

³¹¹ 505 F.2d 350, 355 (D. C. Cir. 1974).

³¹² *Id.*

³¹³ 467 F.2d 787 (6th Cir. 1972).

commenced the civil suit under the FOIA, plaintiff pled *nolo contendere* to the criminal charges and was sentenced to prison. The IRS moved to dismiss the civil suit on the grounds: (1) the plaintiff had failed to seek the Manual through criminal discovery processes and was, therefore, barred from resorting to the equity powers of the court under the Act, since equitable relief cannot be granted where an appropriate remedy at law exists; (2) the IRS Manual is not administrative in nature and therefore does not come under the Act; and (3) if the Manual does come under the Act, then paragraph (b)(2) exempts matters relating solely to the internal personnel rules and practices of an agency. The Sixth Circuit Court of Appeals reasoned that since the plaintiff was still subject to a civil suit by the IRS to recover his underpayment of taxes, and since he had pled guilty to the criminal charges, he would be without a remedy if the court followed the IRS's argument.³¹⁴ Another factor the court considered was that the Act makes information available "to any person" not relying on the identity of the seeker.³¹⁵

In determining whether the IRS Manual is administrative in nature and therefore included in the Act, the court looked to the House Report and Senate Report. Noting the discrepancy in the interpretation of the Act between the two, the *Hawkes* court accepted the Senate Report's version.³¹⁶

Although much activity, which at its inception is administrative in character, ultimately concludes in law enforcement proceedings, this court was of the opinion that it was not the purpose of the Act to deny disclosure to all materials which might eventually affect the law enforcement process.³¹⁷ The court said the law enforcement exception in Section 552(a)(2)(c) is to be applied "only where the sole effect of disclosure would be to enable law violaters to escape detection."³¹⁸

In determining whether the paragraph (b)(2) exemption, for matters relating solely to the internal personnel rules and practices of an agency covered the Manual, the court observed the House-Senate discrepancy again. Since the two views could not be reconciled, the court again adopted the Senate version over that of the House.³¹⁹ The court remanded the case to the district court to decide what materials qualified for disclosure in accordance with the court's opinion.

³¹⁴ *Id.* at 793.

³¹⁵ *Id.* at 790 n. 3.

³¹⁶ *Id.* at 794.

³¹⁷ *Id.* at 795.

³¹⁸ *Id.*

³¹⁹ *Id.*

On remand, the district court ordered all materials requested by the plaintiff to be made available to him. In its appeal,³²⁰ the IRS contended that seventy paragraphs of the Manual "are considered critical" and should not be disclosed since this would "significantly impede" its enforcement program. The IRS argued that the "sole effect" criterion applied by the district court, which was taken directly from the court of appeal's opinion, was too narrow. The appellate court concluded that the district court's conclusion was not clearly erroneous under either the "sole effect" or the "significantly impede" criterion. The court's holding was clearly influenced by the fact that many of the paragraphs in dispute were already available to the public.³²¹

In *Fruehauf Corp. v. Internal Revenue Service*,³²² plaintiff sought private rulings under the FOIA to use in preparation of its defense in a separate criminal proceeding for evasion of manufacturers' taxes. The IRS objected to the disclosure on the grounds that paragraph (b)(3) relating to matters specifically exempted from disclosure by statute was applicable. The IRS cited Section 6103(a)(1), which permits disclosure of returns only by order of the President. In its opinion, the district court relied on the Sixth Circuit Court of Appeals decision in *Hawkes*³²³ and ordered disclosure. The court observed that to the extent that any of the material sought by plaintiff might constitute an invasion of the privacy of taxpayers, "there are means that may be employed to avoid such disclosures."³²⁴

In *Tax Reform Research Group v. Internal Revenue Service*,³²⁵ plaintiff, a "public-interest" group, brought suit under the FOIA to compel the IRS to disclose all confidential comments submitted by taxpayers dealing with various Code sections, and to declare void the unamended Section 601.601(b)³²⁶ which allowed taxpayers to specify which portions of their comments contain confidential information or data. The IRS defended using as a basis paragraph (b)(4), which exempts trade secrets and financial information obtained from a person which is either privileged or confidential. The IRS argued that since Section 601.601(b), prior to April 29, 1973, acted as a promise of confidentiality by the IRS to taxpayers, the court should exercise its equity powers by refusing to order disclosure. The district court replied that it had no equity powers under the Act and that the promise of

³²⁰ 507 F.2d 481 (6th Cir. 1974).

³²¹ *Id.* at 494.

³²² 369 F. Supp. 108 (E. D. Mich. 1974).

³²³ 467 F.2d 787 (6th Cir. 1972).

³²⁴ 369 F. Supp. 108, 110 (E. D. Mich. 1974).

³²⁵ 33 Am. Fed. Tax R. 2d 74-1252 (D. D. C. 1974).

³²⁶ 26 C.F.R. § 601.601(b) (1974).

confidentiality by the IRS was “*ultra vires*”.³²⁷ The court, therefore, declared Section 601.601(b) prior to April 29, 1973 void.³²⁸

In its decision the court cited *National Cable Television Association, Inc. v. F.C.C.*,³²⁹ which held that paragraph (b)(4) only applied to materials “independently confidential” based on their contents and not capable of being rendered anonymous by deletion of identifying information.³³⁰ The court ordered the IRS to disclose the information unless it could demonstrate that it was independently confidential and not susceptible of being rendered anonymous.³³¹

In *Robins & Weill, Inc. v. United States*,³³² plaintiff sought under the FOIA to force the IRS to disclose all internal memoranda containing instructions, statements, or interpretations of policy concerning depreciation of the cost of insurance accounts and expirations. The material sought included private letter rulings and technical advice memoranda. The purpose of this was to aid the plaintiff in the preparation of its petition for a refund of corporate income taxes. Plaintiff wanted such information to obtain corroborative testimony from other taxpayers that the insurance accounts and expirations had a limited useful life. The court denied plaintiff's request to obtain the private letter rulings and technical advice memoranda. The court found that not only had plaintiff failed to show relevancy, materiality, and reasonable specificity, but also, that the private letter rulings and technical advice memoranda could not reasonably be expected to lead to admissible evidence.³³³ The court, however, granted plaintiff's request for copies of the abstract and statement for each offer in compromise accepted by IRS, since these were a matter of public record. The court was of the opinion that the Act does not enlarge the scope of discovery to entitle plaintiff “to engage in a hunting expedition” for anything that might be of aid in its case. Instead, all parties must still adhere to the applicable rules of relevancy, materiality, and reasonable particularity.³³⁴

In *Wine Hobby U.S.A. v. Internal Revenue Service*,³³⁵ plaintiff brought suit under the FOIA to obtain the names and addresses of all persons who have registered with the Bureau of Alcohol, Tobacco, and

³²⁷ 33 Am. Fed. Tax R. 2d at 74-1255.

³²⁸ *Id.* at 74-1257.

³²⁹ 479 F.2d 183 (D. C. Cir. 1973).

³³⁰ *Id.* at 195.

³³¹ 33 Am. Fed. Tax R. 2d at 74-1255.

³³² 63 F.R.D. 73 (N. C. 1974).

³³³ *Id.* at 77.

³³⁴ *Id.*

³³⁵ 502 F.2d 133 (3rd Cir. 1974).

Firearms to produce wine for family use in the Mid-Atlantic region. Plaintiff was engaged in the business of selling and distributing amateur wine-making equipment and supplies. The IRS relied on paragraph (b)(6), which exempts personnel, medical and similar files which would constitute an invasion of personal privacy. The court of appeals accepted this argument relying on the decision in *Getman v. NLRB*.³³⁶ The court found that exemption (b)(6) requires a balancing of the public interest purpose for disclosure against the potential invasion of privacy. Noting that the reason for disclosure in this case was "commercial exploitation", the court held that the lists were exempt from disclosure.³³⁷

It appears difficult to reconcile the *Fruehauf* and *Robins & Weill* cases. The "hunting expedition" that the court believed *Robins & Weill* was engaging in was really not much different than plaintiff's request in *Fruehauf*. In reality all plaintiffs are partaking in a "hunting expedition" when seeking information or rulings from the IRS. If the plaintiffs knew what information was in the IRS's possession, it would not be necessary to resort to judicial proceedings. Conversely, if it is necessary to resort to judicial proceedings, plaintiffs do not know if the information sought will be beneficial to them.

It is certainly arguable that the court reached the right decision in *Robins & Weill*, but for the wrong reasons. The plaintiff in that case wanted the names and addresses of other taxpayers to obtain corroborative testimony from them. The real issue in the case should have been the (b)(6) exemption relating to personal privacy. The *Fruehauf* decision permitted disclosure, but observed that appropriate safeguards could be taken to avoid invasion of privacy. In *Tax Reform Research Group* the court allowed disclosure except for those materials that were "independently confidential". If measures can be taken to render the information anonymous, there appears to be no valid reason to withhold it. In *Wine Hobby*, the information being sought was a list of names, which obviously could not be rendered anonymous.

8.08 Innocent Spouse

An "innocent spouse" is absolved by Section 6013(e) of the Code from joint and several liability for tax, interest, and penalties assessed on income wrongfully omitted from a joint return, when the omission is greater than 25 percent of the gross income stated in the return. Limiting the application of this section to spouses who have filed joint returns, results in a perplexing result where innocent spouses file separate returns in community

³³⁶ 450 F.2d 670 (D. C. Cir. 1971).

³³⁷ 502 F.2d 133, 137 (3rd Cir. 1974).

property states. According to *United States v. Malcolm*,³³⁸ in a community property state, half of each spouse's income is attributable to the other spouse. When filing separate returns, each taxpayer must report half of his income and half of his spouse's income. Under these guidelines, a spouse in a community property state, who is deceived by a husband or wife, and who is not disclosing a portion of gross income, is liable for the tax on half of the unreported income. Although not as broad as the joint and several liability imposed on spouses filing joint returns, this liability is certainly analogous.

In *Mary Lou Galliher*,³³⁹ the spouses filed separately and the taxpayer sought to invoke Section 6013(e) to negate tax liability for the portion of her husband's undisclosed income which was attributable to her. Although this "innocent" spouse position is clearly parallel to that of the deceived spouse who files a joint return, as contemplated by the statute, the Tax Court held that, despite the similarity, relief is available only to spouses filing jointly. This limitation was likewise applied in *Bettie Jane Coffman*,³⁴⁰ even though the deceived spouse neither benefited from, nor had reason to know of, the omitted income.

The "innocent spouse" in *Ann B. Resnick*³⁴¹ met the joint-filing requirement, but failed to satisfy the condition that the augmented tax liability arise from omitted gross income.³⁴² Here, gross income from sales in the husband's business was fully reported on Schedule C, but the cost of goods sold was overstated by nearly four million dollars. Relying on the specific language in Section 6013(e)(1)(A) and Treasury Regulation 1.6013-5(d), the Tax Court again denied relief to the otherwise qualifying spouse, since the increase in the tax liability stemmed from the overstatement of cost, rather than omission from gross income.³⁴³

On June 11, 1975 the Fifth Circuit in *Allen v. Commissioner*³⁴⁴ determined the manner in which the 25 percent test is to be computed under Section 6013(e). Three factors must be considered to qualify the innocent spouse for the exoneration from liability within the meaning of Section 6013(e). First, a joint return must be filed in a taxable year in which there was "omitted from gross income an amount properly includable therein which is attributable to one spouse and which is in excess of 25 percent of

³³⁸ 282 U.S. 792 (1931).

³³⁹ 62 T. C. No. 81 (Sept. 3, 1974).

³⁴⁰ 43 P. H. TAX CT. MEM. ¶ 74,308 (Dec. 12, 1974).

³⁴¹ 63 T. C. No. 48 (Feb. 3, 1975).

³⁴² INT. REV. CODE OF 1954, § 6013(e)(1).

³⁴³ 63 T. C. at 291.

³⁴⁴ 36 Am. Fed. Tax R. 2d 75-5135 (5th Cir. 1975).

the amount of gross income stated on the return." Second, when the other spouse signed the return, he or she must have had no knowledge or reason to know of the omission. Third, all the facts and circumstances of the situation must be taken into account, such as whether the other spouse had benefited directly from the omission and whether it would be inequitable to hold the other spouse liable for the deficiency caused by the omission in the taxable year in question.³⁴⁵

In the instant case, petitioner's joint return stated a gross income of \$235,735. In calculating the amount of omitted income, the Commissioner applied a storage-receipts item, which was overstated by \$66,814.69, due to Lewis Allen's error in implementing the accrual method rather than the cash method. The Tax Court accepted the Commissioner's reasoning as to the 25 percent test, but found that petitioner had no knowledge or reason to know of the omission and that it would be inequitable to hold her liable for any tax deficiency attributable to the omission.³⁴⁶

It is important to recognize that Mrs. Allen was not granted total immunity from taxable liabilities of the year in question. The immunity extended only to income omissions which fulfilled the three requirements of Section 6013(e). Such immunity does not extend to tax liabilities determined by the Internal Revenue to be from properly disallowed deductions.

The purpose of Section 6013(e) is remedial,³⁴⁷ and is intended to protect one spouse from inequalities which are the product of the imposition of joint liability.³⁴⁸ Such statute should be liberally construed in favor of those whom the statute was designed to benefit.³⁴⁹ Application of the Tax Court's reasoning is directly opposed to the stated purpose of the innocent spouse provision. Furthermore, an acceptance of the Commissioner's position would have allowed a single mistake of her former spouse to deny Mrs. Allen of the benefits of the statute, enacted to relieve her from tax liability for such mistakes. The mistakes should not cancel the benefits due Mrs. Allen, especially where the statute does not clearly authorize such action, as argued by the Commissioner.

8.09 Investigation of Books and Records

The question of whether the IRS may issue a "John Doe" summons to a bank to discover the identity of a person whose bank transactions suggest potential liability for unpaid taxes, was answered in the affirmative by the

³⁴⁵ INT. REV. CODE OF 1954, § 6013(e).

³⁴⁶ 36 Am. Fed. Tax R. 2d at 75-5139.

³⁴⁷ *Sanders v. United States*, 509 F.2d 162 (5th Cir. 1975).

³⁴⁸ See S. REP. NO. 91-1537, 91st Cong. 2nd Sess., 6089 (1970).

³⁴⁹ *Helvering v. Bliss*, 293 U.S. 144 (1934).

Supreme Court in *United States v. Bisceglia*.³⁵⁰ The defendant in *Bisceglia* was vice-president of a bank which had accepted for deposit in each of two transactions \$20,000 in \$100 bills which had become unusually thin and severely disintegrated, probably as a result of long-term storage under unusual conditions. Pursuant to the Service's investigatory powers,³⁵¹ an agent issued a "John Doe" summons calling for the production of bank records which would provide information as to the identity of the depositor. The Sixth Circuit held that the summons was invalid since the agent had not ascertained the identity of the depositor prior to issuance. The Supreme Court reversed, holding that the Service's summons power is not exclusively an accusatory device, but may validly be exercised in an investigatory framework.³⁵² Justice Burger stated, further, that the public is protected from abuse of the summons power since only the courts may enforce the summons, and enforcement will be ordered only where the information sought is relevant to a legitimate investigatory purpose.³⁵³

In a later action, the Supreme Court vacated and remanded *United States v. Humble Oil & Refining Company*³⁵⁴ to the Fifth Circuit for review in light of *Bisceglia*. In *Humble*, the IRS issued a "John Doe" summons to Humble Oil for documents pertaining to certain unknown lessors of Humble, whose tax liability was being questioned. Again, the deciding factor will be whether the IRS activity has evolved into an investigation, or is simply research.

8.10 Determining the Existence of a Lease

An agreement which purports to be a lease, but provides for outright ownership of an equity interest in the lessee, may be considered a conditional sale for tax purposes.³⁵⁵ Revenue Ruling 54-540 states that the intent of the parties is controlling in the determination of whether a particular transaction is a sale or a lease, and describes several factual situations where intent to purchase and sell may be implied. Revenue Procedure 75-21,³⁵⁶ on the other hand, establishes criteria for determining the existence of a lease.

In order to qualify the transaction as a lease for advance ruling purposes, the lessor must maintain a minimum unconditional "at risk" investment in the property throughout the term of the lease equal to at least 20 percent of the cost of the property, and show that the property will retain that

³⁵⁰ 420 U.S. 141 (1975).

³⁵¹ INT. REV. CODE OF 1954, § 7602(2).

³⁵² 420 U.S. at 150.

³⁵³ *Id.* at 151.

³⁵⁴ 421 U.S. 943 (1975).

³⁵⁵ Rev. Rul. 54-540, 1955-2 CUM. BULL. 39.

³⁵⁶ Rev. Proc. 75-21, 1975 INT. REV. BULL. No. 18, at 15.

percentage of its original cost and its useful life at the end of the lease term. No lessee may obtain a purchase option at a price less than fair market value at the date exercisable, nor may any lessee furnish any part of the cost of the property. In addition, the lessor must demonstrate that he expects to earn a profit from the transaction, apart from the value of deductions, credits, or other tax benefits.

The procedure for obtaining an advance ruling as to whether the IRS will treat a given transaction as a lease is described in Advance Revenue Procedure 75-28.³⁵⁷ The procedure sets forth the documents and representations which must be filed with the ruling request, and provides that the lessor, lessee, and all other parties with an interest in the transaction must join in the request.

8.11 Interest Rate—Underpayments and Overpayments

The annual rate of interest payable on underpayments and overpayments of tax has been increased to nine percent on amounts outstanding as of July 1, 1975, and on amounts which subsequently arise. The increase is made effective in the form of amendments to appropriate Regulations.³⁵⁸ Interest will run on any underpayment of tax from the original due date to the date on which payment is received, irrespective of any extension. Interest is permitted on a refund from the date of the overpayment to a date which precedes the date of the refund check by not more than 30 days.

8.12 Installment Sales

Section 453 of the Code allows a taxpayer to elect the installment method of reporting profits on the sale of real³⁵⁹ or personal³⁶⁰ property. However, the IRS will deny a taxpayer his election under Section 453 if the taxpayer directly or indirectly maintains control over the proceeds or derives a benefit therefrom.³⁶¹

The case of *Nye v. United States*³⁶² raised the question of whether the sale of securities by a wife to her husband, who later sold the securities, gave the wife direct or indirect control over the proceeds, which would invalidate her election under Section 453. Mary Jane Nye was a doctor and her husband Charles Nye was a lawyer. They maintained separate checking accounts, as

³⁵⁷ Rev. Proc. 75-28, 1975 INT. REV. BULL. No. 21 at 19.

³⁵⁸ Treas. Regs. 1.115-1; 1.514(b)-1; 301.6332-1; 301.6601-1; 301.6602-1; 301.6603-1; 301.6611-1; 1.6654-1; 1.6655-1; 1.6655-5; 301.6863-1.

³⁵⁹ INT. REV. CODE OF 1954, § 453(b)(1)(A).

³⁶⁰ INT. REV. CODE OF 1954, § 453(b)(1)(B).

³⁶¹ See *Griffiths v. Helvering*, 308 U.S. 355 (1939); *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *Everett Pozzi*, 49 T. C. 119 (Nov. 28, 1967); Rev. Rul. 73-157, 1973-1 CUM. BULL. 213.

³⁶² 36 Am. Fed. Tax R. 2d 75-5150 (M. D. N. C. 1975).

well as holding separate investments. The husband was investing in a construction project and his wife sold him some securities for cash and a promissory note, payable in eleven annual installments at an interest rate of four percent. Charles Nye then sold the securities and invested in the construction project.

The husband and wife filed a joint return for the year in which she sold her husband the securities. The sale was reported as having been made on the installment method. The Internal Revenue Service denied the election under Section 453, claiming that Charles Nye acted as an agent for his wife.

The sale of the securities by Mary Jane Nye to her husband had a two-fold purpose: (1) to give her the tax benefit of reporting the sale on the installment method; and, (2) to give her husband a loan at four percent instead of eight percent.³⁶³

However, the district court relying on the decision in *Rushing v. Commissioner of Internal Revenue Service*³⁶⁴ held that a taxpayer can use the installment method to minimize his or her tax, as long as there is a bona fide installment sale.³⁶⁵ A sale of securities between a husband and wife in which the husband later sells the securities by himself may raise the presumption that the husband acted as her agent. But in the instant case, due to the unique circumstances showing that the husband and wife were "two separate, and evidently, very healthy economic entities,"³⁶⁶ there was no way of proving that the wife had any control over the proceeds from the sale. Therefore there was no violation of Section 453. Furthermore, there was no violation of Revenue Ruling 73-157,³⁶⁷ since there was neither any prearranged plan with the construction company, nor any established relationship between the wife and the construction company.

8.13 Employment Tax Deposits

Effective October 1, 1975 Treasury Regulation 31.6302(c)-1 eased the administrative burden on small employers associated with the deposit of certain employment taxes. The revised procedure relieves employers from the quarter-monthly deposit requirements whose aggregate social security and withheld income taxes during the preceding calendar quarter was less than \$25,000. Qualifying employers are required to deposit the employment taxes within 7 days of any day on which the aggregate amount is \$2,000 or more.

³⁶³ 36 Am. Fed. Tax R. 2d at 75-5150-52.

³⁶⁴ 441 F.2d 593 (5th Cir. 1971).

³⁶⁵ 36 Am. Fed. Tax R. 2d at 75-5153.

³⁶⁶ *Id.*

³⁶⁷ Rev. Rul. 73-157, 1973-1 CUM. BULL. 213.

Where the employer's aggregate in the preceding calendar quarter is \$25,000 or more, the quarter-monthly deposit procedure remains in effect.

8.14 False Dependent Claims

It is unlawful for any individual, required by Section 3402 of the Internal Revenue Code to supply information to his employer, to willfully supply false or fraudulent information.³⁶⁸

In order to avoid paying taxes which would support the military establishment, the Quaker defendant in *United States v. Snider*³⁶⁹ filed an Employee's Withholding Allowance Certificate (Form W-4) with his employer claiming three billion dependents on the basis that he and his wife were "conscientiously opposed to any and all wars" and "becoming more and more aware of our responsibilities to our 3 billion fellow human beings."³⁷⁰ The Sniders enclosed a letter addressed to the IRS with the W-4 expressing this rationale. The Fourth Circuit overturned the defendant's district court conviction on the grounds that the information supplied was not false or fraudulent, within the meaning of Section 7205.

Rejecting the government's contention that the word false, as used, means simply untrue, the majority held that a taxpayer cannot be convicted of a Section 7205 violation, unless the information provided is either supplied with an intent to deceive, or is false in the sense of being deceptive; that is, such that it could reasonably affect withholding to the government's detriment.³⁷¹ Applying this test to the facts, the court found that a claim of three billion dependents could deceive no one.

Shortly after the *Snider* decision, James Shea petitioned to have his prior conviction under Section 7205 vacated.³⁷² Shea filed a W-4 claiming twenty dependents, being entitled only to six. He had earlier expressed his intent to resist paying taxes in a letter to the government. The Fourth Circuit, however, refused Shea's petition to vacate, distinguishing *Snider* on the grounds that a claim of twenty dependents was not completely implausible.

Prior to these decisions, the Third and Ninth Circuits upheld convictions under Section 7205 where taxpayers planned to avoid withholding of taxes by claiming fifteen³⁷³ and seventeen³⁷⁴ dependents, respectively.

³⁶⁸ INT. REV. CODE OF 1954, § 7205.

³⁶⁹ 502 F.2d 645 (4th Cir. 1974).

³⁷⁰ *Id.* at 647.

³⁷¹ 502 F.2d at 645.

³⁷² *Shea v. United States*, 506 F.2d 1226 (1974).

³⁷³ *United States v. Malinowski*, 472 F.2d 850 (3rd Cir. 1973).

³⁷⁴ *United States v. Smith*, 487 F.2d 329 (9th Cir. 1973).

8.15 Joint Filing Status—Mexican Divorce

Whether a taxpayer is entitled to file joint returns with his second wife after divorcing his first wife through *ex parte* Mexican proceedings, not recognized in taxpayers domiciliary state, was the issue in *Harold K. Lee*.³⁷⁵ Lee obtained a Mexican divorce from his wife in 1966, and in 1967 married his second wife in Nevada. Although Lee had filed joint returns with the second wife from 1967 through 1970, he instituted divorce proceedings against the first wife in his domiciliary state of California, shortly after his second marriage. In his California complaint, Lee alleged that he was married to the first wife. Lee and the first wife were divorced in 1971 by the state of California, and the IRS assessed deficiencies against Lee and the second wife for 1967 through 1970, contending that Lee and the second wife were not husband and wife during these years within the meaning of Section 6013(a).

Lee relied on *Borax v. Commissioner*³⁷⁶ for the proposition that the marital status of taxpayers should be determined by a uniform federal standard, rather than the rule in the domiciliary state. *Borax* held that a taxpayer may be considered divorced for tax purposes where he has obtained a divorce in a Mexican proceeding, although not recognized in the domiciliary.

The Tax Court, however, chose not to follow the *Borax* rule, holding that marital status is a fact to be determined by state law. Since the Mexican divorce was inferentially considered a nullity by the subsequent California divorce, Lee and his second spouse were not "husband and wife" during the period in question, and were, therefore not entitled to file jointly.³⁷⁷

8.16 Income Averaging—Support Requirement

An individual is not eligible to use the income averaging method if, for any base period year, he furnished less than one-half of his support.³⁷⁸ Section 1302(c)(3) defines a base period year as any of the four taxable years immediately preceding the computation year.

Upon the request of a taxpayer who had received a scholarship during a base period year which exceeded the amount otherwise used for his support, the IRS ruled that the taxpayer had not met the eligibility requirement with respect to support.³⁷⁹ The ruling states that in determining whether the

³⁷⁵ 64 T. C. No. 52 (July 8, 1975).

³⁷⁶ 349 F.2d 666 (2nd Cir. 1965).

³⁷⁷ 64 T. C. at 309.

³⁷⁸ INT. REV. CODE OF 1954, § 1303(c)(1).

³⁷⁹ Rev. Rul. 75-40, 1975 INT. REV. BULL. No. 6, at 21.

taxpayer has, together with his spouse,³⁸⁰ furnished 50 percent of his support, that a comparison should be made between the amount furnished by the individual and his spouse, and the total amount of support received from all sources, including "food, shelter, clothing, medical and dental care, education, and the like."³⁸¹

8.17 Informal Settlement Agreement—Estoppel

In *Stair v. United States*,³⁸² the Second Circuit held that equitable estoppel precludes a taxpayer from claiming a refund, where the income tax was paid pursuant to an informal agreement with the IRS (Form 870-AD).³⁸³ The dispute centered on a deficiency assessed on the condemnation proceeds from a sale of land owned by Stair. The IRS maintained that the land was held for sale to customers in Stair's ordinary course of business, as a land developer. Stair, however, claimed capital gains treatment for the proceeds.

In settlement of the matter, which arose in the 1964 tax year, the parties executed an informal agreement on Form 870-AD in 1966. The agreement provided for payment of approximately half of the disputed amount, and for the taxpayer to file "no claim for refund or credit". Stair paid the agreed deficiency in December, 1966, but filed for a refund in 1968, contrary to the prohibition in the agreement.

Although execution of the Form 870-AD is not in itself binding on the parties,³⁸⁴ the court held that the taxpayer was estopped from filing for the refund. The court found that the taxpayer's representation, that he would not file for a refund, coupled with his subsequent filing for refund, amounted to a misrepresentation which justified the application of estoppel principles.³⁸⁵ An additional factor which influenced the court was the fact that the statute of limitations for assessment of a deficiency on the portion of the original disputed amount which remained unpaid had expired.³⁸⁶ Allowing Stair to prevail would have encouraged other taxpayers to execute informal settlements with the IRS, and then seek refunds for the settled amounts in a later year.

³⁸⁰ Treas. Reg. 1.1303-1(c)(1).

³⁸¹ Rev. Rul. 75-40, 1975 INT. REV. BULL. No. 6, at 22.

³⁸² 516 F.2d 560 (2nd Cir. 1975).

³⁸³ The form is titled: "Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment."

³⁸⁴ *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929).

³⁸⁵ 516 F.2d at 565.

³⁸⁶ INT. REV. CODE OF 1954, § 6501(a).

8.18 Unclaimed Depreciation

The taxpayer in *Gardiner v. United States*³⁸⁷ purchased depreciable rental property, but failed to claim depreciation deductions in her federal income tax returns for the first three years of ownership. She claimed the appropriate deductions in the fourth through the seventh years, and sold the property in the eighth year. Gardiner calculated her gain on the transaction, using cost less the claimed depreciation for four years as the basis, which yielded a loss on the transaction. The IRS, however, recomputed the basis as cost less claimed and unclaimed depreciation, which yielded a gain on the transaction. Gardiner then filed for a refund of taxes paid during the first three years in which the depreciation was not claimed, but the refund was barred by the statute of limitations.³⁸⁸

Finally, the taxpayer sought to "reopen" the barred tax years through the mitigation provisions of Sections 1311-14. The District Court of Utah concluded that the only section under which plaintiff's claim might be reopened was Section 1312(7), and examined the facts of the case only with reference to that section. Section 1312(7)(c) requires that there must have been prior erroneous treatment with respect to the taxpayer in the form of an erroneous inclusion or omission from gross income, an erroneous recognition or nonrecognition of gain or loss, an erroneous deduction of a capital item, or erroneous capitalization of a deductible item.

The plaintiff cited *M. Fine & Sons Mfg. Co., Inc. v. United States*³⁸⁹ as support for the proposition that unclaimed depreciation amounts to an erroneous overstatement (inclusion) of gross income. The district court, however, distinguished *Fine* on the grounds that *Fine* involved a manufacturing operation where unclaimed depreciation could understate cost of goods sold and thereby result in overstated income. The court held that no such overstatement results where property is held to produce rents and where the depreciation is a deduction from gross income. Thus, plaintiff's situation did not satisfy the requirements of Section 1312(7) and she was denied the benefit of its mitigation provisions.

8.19 Bankruptcy Court—Jurisdiction

In *Phelps v. United States*,³⁹⁰ the Supreme Court resolved a conflict between two circuits on the question of whether service of a notice of levy

³⁸⁷ 35 AM. FED. TAX R. 2d 75-1112 (D. Utah 1975).

³⁸⁸ INT. REV. CODE OF 1954, § 6511(a). This section requires that a claim for credit or refund for overpayment be filed within three years of the time of filing, or two years of the time of payment of the tax, whichever is later.

³⁸⁹ 168 F. Supp. 769 (Ct. Cl. 1958).

³⁹⁰ 421 U.S. 330 (1975).

by the IRS on the assignee of a bankrupt taxpayer deprives the bankruptcy court of jurisdiction to turn over the levied assets to the receiver.

The Ninth Circuit had held that the levied assets were subject to the bankruptcy court's summary jurisdiction to enter a turnover order, provided the assignee makes no claim to the assets.³⁹¹ The Seventh Circuit, in *Phelps*, ruled that once the IRS lien was filed and the assignee was notified, the turnover order may not issue without the consent of the United States.³⁹²

The Supreme Court affirmed the Seventh Circuit, holding that the levy created a custodial relationship between the assignee and the United States, and that the Government thereby obtained constructive possession of the assets through the assignee.³⁹³ The levy, then, gave the United States, as opposed to the assignee or the receiver, the right to the assets, thus depriving the bankruptcy court of the authority to issue the turnover order.

8.20 Declaratory Judgment

Prior to the execution of a planned merger between Hartford Fire Insurance Company and ITT Hartford Fire Insurance Corporation (a wholly-owned subsidiary of International Telephone and Telegraph), ITT requested and received two rulings from the Commissioner of Internal Revenue which qualified the proposed merger as a tax-free reorganization. After an exchange offer to the Hartford Fire Insurance Company shareholders had been made assuring the offeree-shareholders that the transaction would be tax-free, the Commissioner revoked the two rulings on the grounds of alleged misrepresentation by ITT. The Service then assessed deficiencies against exchanging shareholders, and ITT brought an action in district court,³⁹⁴ seeking a judgment declaring the Commissioners revocation invalid.

Although ITT had standing to maintain the action, the district court of Delaware held that it did not have jurisdiction to grant the desired remedy.³⁹⁵ Section 7421 of the Internal Revenue Code, commonly known as the "Anti-Injunction Act", prohibits suits which seek to restrain the assessment or collection of taxes. In addition, the Declaratory Judgment Act contains an express denial of jurisdiction in federal courts where the remedy sought is a declaration "with respect to Federal taxes".³⁹⁶ These statutes denied the

³⁹¹ *In re United General Wood Products Corp.*, 483 F.2d 975 (9th Cir. 1973).

³⁹² 495 F.2d 1283 (7th Cir. 1974).

³⁹³ 421 U.S. at 334.

³⁹⁴ *ITT v. Alexander*, 36 Am. Fed. Tax R. 2d 75-5695 (D. Del. 1975).

³⁹⁵ *Id.*

³⁹⁶ 28 U.S.C. § 2201 (1970).

court subject matter jurisdiction in the controversy, and the Commissioner's motion to dismiss was, therefore, granted.³⁹⁷

8.21 Informal Pre-ruling Conferences

Revenue Procedure 75-23³⁹⁸ reported an expansion of the Service's informal conference program. Revenue Procedure 74-19³⁹⁹ had announced a program under which the Reorganization and Excise Branches within seven days of a ruling request would contact taxpayers seeking rulings for an informal discussion of the Service's probable position in the matter. Under the new procedure the program is expanded to include an informal discussion within fifteen days after receipt of requests for certain rulings from the Individual Income Tax Branch,⁴⁰⁰ the Corporation Tax Branch,⁴⁰¹ the Employment Tax and Administrative Provisions Branch,⁴⁰² and all other requests received by the office of the Assistant Commissioner (Technical).

Although the IRS will not be bound by the informal opinion, the Branch representative will inform the taxpayer as to how he will recommend that the Service rule on the issue and, if something less than a favorable ruling is indicated, how the taxpayer's transaction might be modified to permit issuance of a favorable ruling. The program is expanded on a test basis, and will expire July 1, 1976.

9.00 Inventory

9.01 Full Absorption Regulations

A manufacturer's taxable income will vary directly with the value of his ending inventory. If a manufacturer understates his ending inventory by excluding various indirect production costs, the cost of goods sold will be overstated, thereby causing an understatement of taxable profit. The Commissioner has realized the need to control this particular situation and has now made it mandatory for all taxpayers to adopt the full absorption method of costing inventories.⁴⁰³ The Treasury regulations now enumerate which

³⁹⁷ 36 Am. Fed. Tax R. 2d at 75-5708.

³⁹⁸ Rev. Proc. 75-23, 1975 INT. REV. BULL. No. 17, at 20.

³⁹⁹ Rev. Proc. 74-19, 1974-2 CUM. BULL. 465.

⁴⁰⁰ Included are the following subject matters: Partnerships and trusts, Code Section 103, real estate investment trusts, stock options, charitable remainder trusts, and pooled income funds. Rev. Proc. 75-23, 1975 INT. REV. BULL. No. 17, at 20.

⁴⁰¹ Excluded are requests relating to the following subject matters: Change in accounting method or period, last-in-first-out method of computing inventory, and insurance issues involving contracts with reserves based on segregated asset accounts or requiring actuarial computations. *Id.* at 20-21.

⁴⁰² *Id.* Requests from individuals for employment status and submitted on Forms SS-8 are excluded.

⁴⁰³ Treas. Reg. § 1.471-11(a):

In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by §471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventorial costs

indirect costs are includable or excludable in computing ending inventory costs.

Section 1.471-11(c)(2) lists three categories of indirect production costs. The first category includes the costs which are always required to be included in determining inventory costs.⁴⁰⁴ The second category includes the costs which are not included in determining inventory costs.⁴⁰⁵ A third category of indirect production costs are includable or excludable from inventory costs depending on how the taxpayer treats such items in his financial reports and whether they are in accordance with generally accepted accounting principles.⁴⁰⁶

Section 1.471-1(c)(2)(i) and (ii) establish fixed rules for determining which costs are includable and which are excludable. However, Section 1.471-1(c)(2)(iii) provides a flexible rule in determining whether a taxpayer will include or exclude certain indirect production costs. The flexibility of the rule provides for fluctuations in industry or business practices, again, as long as the costs are within the scope of generally accepted accounting principles. There is a two step approach in the use of this rule. First, a financial report text is used as an objective measure to establish whether or not the indirect production costs should be included or excluded. If the indirect cost has not or will not be used in determining the taxpayer's inventory for financial statement purposes, then it may be excluded from the taxpayer's inventory on his tax return.⁴⁰⁷ Second, the exclusion will be allowed only if generally accepted accounting principles have established the appropriateness of the exclusion for the taxpayer's business or industry.⁴⁰⁸

However, the Commissioner claims:

. . . that some taxpayers have attempted to exclude some or all costs under Section 1.471-11(c)(2)(iii) of the regulation as not inconsistent with generally accepted accounting principles on the basis of consistency of treatment and materiality.⁴⁰⁹

The Commissioner has stated that the rule is not being applied properly by the taxpayers.⁴¹⁰ In order to insure that the regulations are

⁴⁰⁴ Treas. Reg. § 1.471-11(c)(2)(i).

⁴⁰⁵ Treas. Reg. § 1.471-11(c)(2)(ii).

⁴⁰⁶ Treas. Reg. § 1.471-11(c)(2)(iii).

⁴⁰⁷ *Id.*

⁴⁰⁸ *Id.*

⁴⁰⁹ T. I. R. 1365, 6 P-H 1975 FED TAXES ¶ 55,221.

⁴¹⁰ *Id.*

properly interpreted the Commissioner has issued Announcement 75-42.⁴¹¹ This procedure will require the taxpayer to judge each item of indirect inventory cost on the basis of generally accepted accounting principles "without regard to consistency of treatment or the materiality of such costs."⁴¹²

The procedure will also require a taxpayer who is changing to the full absorption method to make one of the following representations with respect to each item of cost included in the third category: (1) If a taxpayer is going to exclude certain costs under Section 1.471-11(c)(2)(iii) on the basis of consistency with financial report, he must submit a statement to the Commissioner from his independent public accountants that the exclusion of such costs are not inconsistent with generally accepted accounting principles, which must be made without regard to consistency or materiality;⁴¹³ (2) If a taxpayer is going to exclude certain indirect inventory costs for income tax purposes, and he is also going to change his method of determining inventory cost for financial statement purposes (thereby excluding certain indirect inventory costs from his financial report), he must present a statement to the Commissioner from his independent public accountant stating that either (A) the change in method for financial reporting of inventory costs is preferable in the taxpayer's business or (B) the change "is consistent with Opinion No. 20 issued by the Accounting Principles Board of the American Institute of Certified Public Accountants."⁴¹⁴ With respect to A and B above, each item of cost must be considered separately "without regard to the materiality of such costs."⁴¹⁵

Announcement 75-42 has caused a conflict to arise between the Commissioner and the American Institute of Certified Public Accountants (A.I.C.P.A.). The A.I.C.P.A. in a statement to the Commissioner has opposed the adoption of this procedure.⁴¹⁶ The A.I.C.P.A. believes that, first, since the generally accepted accounting principles have been used as a standard in the enforcement of Section 1.471-11(c)(2)(iii), the standard should be applied in the same manner as the accounting profession applies it, and not in a different manner as interpreted by the Commissioner.⁴¹⁷ Secondly, the A.I.C.P.A. asserts that generally accepted accounting principles have always considered materiality and consistency. The removal of such

⁴¹¹ Announcement 75-42, 1975 INT. REV. BULL. No. 19.

⁴¹² T. I. R. 1365, 6 P-H 1975 FED. TAXES ¶ 55,221.

⁴¹³ *Id.*

⁴¹⁴ *Id.*

⁴¹⁵ *Id.*

⁴¹⁶ Forster, *Full Absorption Inventory Costing*, 6 TAX ADVISER 424 (July 1975).

⁴¹⁷ *Id.* at 425-26.

considerations would be inappropriate. Also, the evaluation of costs on an item-by-item basis is contrary to Accounting Principles Board Opinion No. 20, in that all costs must be considered as a whole in determining materiality. The new procedure additionally will determine whether to include or exclude costs based on generally accepted accounting principles in the taxpayer's trade or industry. The A.I.C.P.A. believes that "this presupposes the existence . . . of industry-by-industry guidelines for various items of overhead to be included in or excluded from inventory . . . [S]uch guidelines do not exist."⁴¹⁸ Finally, many taxpayers have already adopted the full absorption method since the beginning of the two-year transitional⁴¹⁹ period (which began September 19, 1973, and will end September 19, 1975).⁴²⁰

The issue that arises from this situation is the treatment under the new procedure to be given taxpayers who have already made the transition. Although no formal decision has been made by the Commissioner, it is possible that the taxpayer will have to reapply in order to ensure that all taxpayers will be subject to uniform standards. However, the Commissioner would not be able to impose any new requirements on a taxpayer who has already received an approval for a change to the full absorption method and has relied on it.

9.02 Change from FIFO to LIFO Method of Inventory Valuation

The more popular procedure of valuing inventories is the first-in, first-out, or FIFO method. The FIFO method of valuing inventories charges the oldest items in the inventory to cost of goods sold. Traditionally, these items have the lowest cost during periods of inflation. FIFO also values the ending inventory at the most recent cost. This results in high profits which causes higher taxes and an ultimate reduction in cash flow. Without an adequate cash flow many corporations are not able to replace their inventories.

Under the LIFO method which stands for last-in, first-out, the most recent cost of an inventory item is charged to cost of goods sold. LIFO reduces profits and income taxes by matching the current revenues with the current high cost of inventories. Also, under LIFO, the ending inventory is valued at the oldest costs. This results in lower income and lower taxes.

Since the LIFO method is desirable during inflationary periods, the Commissioner is being flooded with Forms 970.⁴²¹ However, the Internal Revenue Service requirements for a proper election of a switch to LIFO

⁴¹⁸ *Id.*

⁴¹⁹ *Id.* at 428.

⁴²⁰ Treas. Reg. § 1.471-11(e)(ii).

⁴²¹ Treas. Reg. § 1.472-3(a). "The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year . . . Form 970"

are very complex, and if not properly complied with, a taxpayer could lose his LIFO election. The taxpayer would then have to pay taxes on income determined by his former inventory method.

Revenue Ruling 74-586⁴²² stated that if a taxpayer using the LIFO method made any comparison of earnings or earnings per share under another method reported in financial statements, annual reports and news releases after January 8, 1975, then, his LIFO election could be terminated. The use of any method other than LIFO is a violation of Section 472(c) and (e). The ruling also stated that the only exceptions would be those permitted by Revenue Procedures 72-29,⁴²³ 73-37,⁴²⁴ and Revenue Ruling 73-66.⁴²⁵ These exceptions apply only to specific transactions and they are rarely used.

The problem the taxpayer faced was disclosing the change from FIFO to LIFO as required by the Security and Exchange Commission⁴²⁶ and various accounting rules. If the taxpayer made the disclosure, he would violate Section 472 and thereby lose his LIFO election. If he did not make the disclosure he would then violate the Securities and Exchange Act of 1934.⁴²⁷

The Internal Revenue Service has resolved this problem by way of Revenue Procedure 75-10⁴²⁸ which states that a taxpayer who elects to switch to the LIFO method will not have his election terminated merely because he makes disclosures in financial statements, annual reports and news releases as required by Accounting Principle Board Opinions 20 and 28 (A.P.B. 20 and 28), Financial Accounting Standards Board 3 (F.A.S.B. 3), Accounting Series Release 159 (A.S.R. 159), Rule 3-07 of the Securities and Exchange Commission Regulations S-X (Rule 3-07) and Securities Act of 1934 Release Number 11079 (Release No. 11079). The purpose of Revenue Procedure 75-10⁴²⁹ was to amplify Revenue Procedure

⁴²² Rev. Rul. 74-586, 1974 CUM. BULL. 156.

⁴²³ Rev. Proc. 72-29, 1972-1 CUM. BULL. 757, provides that a LIFO election would not be terminated because of variations for financial and tax purposes caused by the use of accounting principles in certain business combinations.

⁴²⁴ Rev. Proc. 73-37, 1973-2 CUM. BULL. 501, states that a taxpayer will not lose his LIFO election merely because he discloses the effect of the change in method in his financial statements as required by Accounting Principles Board Opinion 20.

⁴²⁵ Rev. Rul. 73-66, 1973-1 CUM. BULL. 218, states, in effect, that conformity requirements would not be violated if the footnote disclosed only the difference in inventory value of the FIFO over the LIFO method.

⁴²⁶ 17 C.F.R. § 210.3-07(a) (1972).

⁴²⁷ 15 U.S.C. § 78(m) (1934).

⁴²⁸ Rev. Proc. 75-10, 1975 INT. REV. BULL. No. 7, at 16.

⁴²⁹ *Id.*

73-37,⁴³⁰ permitting the taxpayer to make proper disclosures.

Rule 3-07 requires that a disclosure of the effect of the change to LIFO be repeated in subsequent years when the taxpayer's financial statements for the year of change are being reported. Release No. 11079 requires that a five year summary of operations be included in the Annual reports to show the effect of the change to LIFO. Revenue Procedure 75-10⁴³¹ makes it very clear that "such disclosure is strictly limited to the effect on the year of change included in such summary and not for subsequent taxable years."⁴³² Any disclosure of the effect of the switch to LIFO on income in a subsequent year will terminate the LIFO election.

Another problem the taxpayer faced was the disclosure by way of footnote or parenthetical of the "excess of replacement cost or current cost over LIFO stated value"⁴³³ as required by the Securities and Exchange Commission. Prior to Revenue Ruling 75-50,⁴³⁴ a taxpayer would lose his LIFO election if he made such a disclosure.⁴³⁵ The only disclosure permitted in a footnote or parenthetical was the difference in the inventory value of FIFO over LIFO method.

There was also the question of whether or not a taxpayer would lose his LIFO election, if he elected the LIFO method for tax purposes, while issuing financial statements for the same year using the FIFO method to value inventories. By way of Revenue Ruling 75-49⁴³⁶ the Internal Revenue Service has warned the taxpayer that in the year in which he elects the LIFO inventory method, this election will be terminated if the taxpayer has used a method other than LIFO in issued annual reports. The use of another method violates the requirements of Section 472(c) of the Code and Treasury Regulation 1.472-2(c). Reissuance of new statements using the LIFO method or recall of the already issued financial statements will not cure the failure to comply with the requirements.⁴³⁷

A taxpayer who elects to use the LIFO method is further required to value his opening inventory at cost.⁴³⁸ Therefore, any write-down or mark-down to market value must be restored. An amended return for the taxable

⁴³⁰ Rev. Rul. 73-37, 1973-2 CUM. BULL. 501; *accord*, Rev. Proc. 75-10, 1975 INT. REV. BULL. No. 7, at 16.

⁴³¹ Rev. Proc. 75-10, 1975 INT. REV. BULL. No. 7, at 16.

⁴³² *Id.*

⁴³³ 17 C.F.R. § 210.5-02(6)(B).

⁴³⁴ Rev. Rul. 75-50, 1975 INT. REV. BULL. No. 7, at 11.

⁴³⁵ Rev. Rul. 73-66, 1973-1 CUM. BULL. 218.

⁴³⁶ Rev. Rul. 75-49, 1975 INT. REV. BULL. No. 7, at 11.

⁴³⁷ *Id.*

⁴³⁸ Treas. Reg. § 1.472-2(B).

year prior to the LIFO election may have to be filed, which usually means paying additional tax.

There have been many changes this year which have helped to resolve some of the conflicts caused by the taxpayer's duty to disclose changes in inventory method (as required by the Securities and Exchange Commission and various accounting rules) and the Commissioner's requirement of non-disclosure of any method other than LIFO. However, the requirements for a proper election of a switch to LIFO remain very complex and the taxpayer will have to proceed very carefully when making his election. A single violation of any requirement could cause the taxpayer to lose his LIFO election.

10.00 Pension, Profit Sharing, and Stock Ownership Plans

10.01 Employee Pension and Retirement Trusts

Under Section 404 contributions made to a "stock bonus, pension, profit-sharing or annuity plan"⁴³⁹ by an employer, will not be deductible under Sections 162 or 212, unless they meet the requirements of either of those sections. If the requirements of Section 162 or 212 are met, the contributions to a stock bonus, pension, profit-sharing or annuity plan will be deductible when paid, if the specific plan is exempt under Section 501(a). The first concern is determining what qualifies as a contribution to the plan. Cash or property⁴⁴⁰ will qualify as a valid contribution. But, until recently, it was unclear whether an unsecured note given by an employer would qualify as a valid contribution to an employee pension trust and employee retirement trust plan.

The Tax Court clarified the issue in *Lancer Clothing Corporation*⁴⁴¹ by ruling that an unsecured note given to an employee pension trust and employee retirement trust plan did not qualify as a contribution for a deduction. In *Lancer Clothing*, the petitioner was an accrual basis taxpayer. In 1967, the company issued \$39,978 of unsecured interest bearing promissory notes to its employee pension trust and employee retirement trust plans. The company took a deduction for the contribution pursuant to Section 404. The notes were paid in full when due in 1969.

The Internal Revenue Service disallowed the deduction, stating that an unsecured note was not considered a payment under Section 404. The petitioner claimed that the payment of the unsecured notes was within the meaning of Section 404(a), relying on *Wasatch Chemical Company v.*

⁴³⁹ INT. REV. CODE OF 1954, § 404(a).

⁴⁴⁰ Colorado National Bank, 30 T. C. 933 (1958).

⁴⁴¹ 44 P-H TAX CT. MEM. ¶ 75,180 (June 9, 1975).

Commissioner,⁴⁴² which held that the delivery of a taxpayer's own promissory note to an employer's trust constituted payment for the purpose of Section 404(a). However, subsequently, the Internal Revenue Service in Revenue Ruling 71-95⁴⁴³ refused to recognize the *Wasatch* decision.

Petitioner further relied on the case of *Colorado National Bank*,⁴⁴⁴ which held that a payment to a pension fund of property was acceptable, and argued that his unsecured notes should be considered property. However, the Tax Court relied on the case of *Don E. Williams*,⁴⁴⁵ which held that a promissory note given to a pension trust was not transferred property as such and does not qualify as payment under Section 404(a). The Court further stated that the property in *Colorado National* was real, rather than personal; therefore, petitioner's argument did not come within the parameters of the *Colorado* decision.

The *Lancer* court also stated that an unsecured promissory note "merely suspends the underlying obligation until the instrument is paid."⁴⁴⁶ Thus, a promissory note can not be considered final payment when delivered to the employee pension trust and employee retirement trust plans.

Finally, the court stated that it was not the intent of Congress "that the issuance of an unsecured note should be considered payment under Section 404(a)."⁴⁴⁷

In the future, all employers should contribute cash or real property to the funds, since any use of unsecured promissory notes will most likely result in the loss of the deduction under the *Lancer Clothing Corporation* decision.

10.02 Federal Civil Service Retirement Fund

As privately employed and self-employed taxpayers have been allowed increasing latitude in making payments to pension funds and excluding these payments from taxable income, Federal employees have often argued that their contributions to the Federal Civil Service Retirement Fund should be deductible. In *Hogan v. United States*,⁴⁴⁸ the Sixth Circuit joined the Third⁴⁴⁹ and Fourth⁴⁵⁰ Circuits in denying the Federal employees a deduction

⁴⁴² *Wasatch Chemical Co. v. Comm'r*, 313 F.2d 843 (10th Cir. 1963).

⁴⁴³ Rev. Rul. 71-95, 1971-1 CUM. BULL. 130.

⁴⁴⁴ *Colorado National Bank*, 30 T. C. 933 (1958).

⁴⁴⁵ 62 T. C. 166 (May 14, 1974).

⁴⁴⁶ 44 P-H TAX CT. MEM. ¶ 75-180 (June 9, 1975). See UNIFORM COMMERCIAL CODE § 3-802.

⁴⁴⁷ 44 P-H TAX CT. MEM. ¶ 75,180 (June 9, 1975).

⁴⁴⁸ 35 Am. Fed. Tax R. 2d at 75-1024 (6th Cir. 1975).

⁴⁴⁹ *Megibow v. Commissioner* 218 F.2d 687 (3rd Cir. 1955).

⁴⁵⁰ *Miller v. Commissioner* 144 F.2d 287 (4th Cir. 1944).

for their contributions to the Federal Civil Service Retirement Fund.

In *Hogan*, the taxpayer argued that the contributions to the plan should be treated as having been made by the employer and should therefore not be taxable to the employee until it is received by him. The court observed that the statutory language regulating the amount to be withheld for the Retirement Fund creates a presumption that the federal employee "is deemed to consent and agree to these deductions from his basic pay."⁴⁵¹ The *Hogan* court also noted that Congress was fully cognizant of the income tax consequences under the Federal Civil Service plan and could change the classification of the contributions from employee to employer, if it so desired.

It is apparent from the *Hogan* decision that relief for federal employees in this area must come from Congress and not the courts.

10.03 Profit Sharing Plan

In the case of *Ronald C. Packard*,⁴⁵² three dentists in a partnership formed a corporation, making themselves the sole shareholders and directors of the corporation. After transferring the office building and dental equipment used in their practice to the corporation, they leased the building and equipment back to the partnership. On August 1, 1968 the partnership transferred all employees to the corporation. The partnership and the corporation then entered into a contract for the corporation to supply complete services to the partnership (building, equipment, janitorial services, employees, bookkeeping, etc.).

On August 21, 1968 the three dentists as partners initiated a profit-sharing plan which covered only themselves. The dentists then filed Form 3672, as required by the Internal Revenue Service, for the purpose of having their profit-sharing plan approved. The request was denied by the Internal Revenue Service since it did not include the employees who were transferred to the corporation. The Internal Revenue Service stated that since the employees still performed the same services and were still under the supervision of the three partners, they remained employees of the partnership.⁴⁵³ The deductions which the partners took for their contributions to the plan in 1968 and 1969 were consequently disallowed by the Internal Revenue Service.

Section 401(d)(3) requires that any profit-sharing plan cover all employees who have three or more years service with the self-employed

⁴⁵¹ Civil Service Retirement Act, 5. U.S.C. § 8334(b) (1970).

⁴⁵² 63 T. C. No. 59 (March 11, 1975).

⁴⁵³ Rev. Rul. 68-303, 1968-1 CUM. BULL. 165.

person. Five employees of the dental partnership had been employed full-time for three years or more and, therefore, according to the Internal Revenue Service, should have been included under the profit-sharing plan.⁴⁵⁴

The respondent relied on Revenue Ruling 68-303⁴⁵⁵ in which another partnership transferred its employees to a corporation and then leased them back to the partnership. The employees continued to be supervised as before, and performed the same services. The only functions the corporation performed were providing insurance and issuing paychecks to the employees.

In *Packard* the situation is similar to that in Revenue Ruling 68-303 but not exactly on point. The partners in *Packard* did have the same people working for them, but the employees were subject to the complete control of the corporation. The partnership desired competent personnel; the corporation was to supply that personnel and maintain supervision to assure proper performance of job duties. Further, the corporation was vested with the authority to discharge employees. There was no relationship between the employees salaries, which were paid by the corporation, and the payment made to the corporation by the dentists for personnel services rendered. The corporation also performed all employee-related functions, including supervision which further substantiated the fact that the employees were employed by the corporation as opposed to the partnership. The Tax Court therefore held that the profit-sharing plan was not disqualified under Section 401(d)(3). Thus, the principle difference that qualified the *Packard* plan was the corporation's providing a *complete* personnel function as opposed to the mere provision of employees found in the 68-303 situation.

The Internal Revenue Service has issued a new Revenue Ruling concerning employee coverage requirements. Revenue Ruling 75-35⁴⁵⁶ involved a physician who set up a service corporation and transferred his employees to the corporation. At the same time, the physician formed a professional corporation which leased back the employees. The Internal Revenue Service stated that the individuals were employees of the professional corporation since they performed the same services as they did before.

Revenue Ruling 75-35 would not control a *Packard* situation. The service corporation in *Packard* provided services to other doctors, supplied the doctors with complete service as opposed to just employee service, and exercised control over the employees. Therefore, by using *Packard's* method of setting up a service corporation, a partnership would be able to set up a

⁴⁵⁴ 63 T. C. at 349.

⁴⁵⁵ Rev. Rul. 68-303, 1968-1 CUM. BULL. 165.

⁴⁵⁶ Rev. Rul. 75-35, 1975 INT. REV. BULL. No. 6, at 6.

profit-sharing plan under Section 401 without including employees. However, there is one danger in setting up a professional corporation and a service corporation with both corporations having the same shareholders: Under the Employee Retirement Income Security Act⁴⁵⁷ the two corporations may be considered part of a controlled group⁴⁵⁸ of corporations and the employees of the service corporation could still be considered employees of the professional corporation. Such a result would require inclusion of all employees of the professional corporation in the profit-sharing plan for it to be valid.

Furthermore, consolidation of the separate entities could result from the language of Section 414(c); the employees of any ". . . trade or business (whether or not incorporated) which are under common control shall be treated as employed by a single employer."⁴⁵⁹ For example, if a partnership owned 50 percent of a service corporation, the employees of the corporation could be considered as employees of the partnership. In essence, the controlled group problem cannot be avoided by setting up a partnership, as opposed to a professional corporation.

Thus, there are two potential solutions to the controlled group problem. One is illustrated by the *Packard* approach, *i.e.*, setting up a service corporation. However, it should be noted that the *Packard* case is unique in a controlled group situation. A very fine line is drawn between control under Section 1563 and the result in the *Packard* case.

There does appear to be another solution. A second approach is the creation of a service corporation by an individual not associated with the partnership or professional corporation. Employees of the latter could then be transferred to the service corporation and leased back to the partnership or professional corporation. No problem with controlled groups would arise as there would be no common stock ownership. The partnership would supervise employees and maintain their standard of work, while the service corporation would still retain authority over the employees as their employer. If the corporation could also extend the same services to other doctors, there would be a further indication that there was a valid business purpose for setting up the corporation.

⁴⁵⁷ The Employee Retirement Income Security Act of 1974, Act of Sept. 2, 1974, Pub. L. No. 93-406, § 1, 88 Stat. 829 (hereinafter referred to as ERISA).

⁴⁵⁸ INT. REV. CODE OF 1954, § 414(b). A controlled group of corporations is defined in INT. REV. CODE OF 1954, § 1563(a)(1), as one or more chains of corporations connected through 80 percent stock ownership with a common parent. INT. REV. CODE OF 1954, § 1563(a)(2), (3) concerns brother-sister controlled groups and combined groups respectively.

⁴⁵⁹ INT. REV. CODE OF 1954, § 414(c).

10.04 Employee Stock Ownership Plans*

The term Employee Stock Ownership Plan (ESOP) was introduced into the Internal Revenue Code by the Employee Retirement Income Security Act of 1974 (ERISA).⁴⁶⁰ The philosophy supporting the ESOP form of employee benefit is to provide capital stock ownership for those persons that supply the labor to produce the goods. It is an attempt, as stated by Senator Long:

[To] move toward the day when many in this country will own an interest in the means by which wealth is produced—I refer to the tools, rather than the labor in this case—rather than the means or production being owned by about 3% of the people, as is the case today.⁴⁶¹

The term Employee Stock Ownership Plan is defined in ERISA as an individual account plan which is a stock bonus plan designed to invest primarily in employer securities.⁴⁶² A stock bonus plan is a “plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits, and the benefits are distributable in stock of the employer company.”⁴⁶³

This type of stock bonus plan is composed of two parts. The first is the ESOP and the second is the Employee Stock Ownership Trust (ESOT). Like other deferred plans, the ESOT must satisfy the requirements of Section 401(a) to gain the federal tax advantages flowing to qualified plans. In operation, the corporation would make contributions to the ESOT, in accordance with the plan, by issuing treasury stock or authorized, but not previously issued stock, to the ESOT which would in turn allocate the stock to the employees' account. As the employees' rights gradually vest, they become beneficial owners of the company. The stock need not be voting common but can be preferred or any class which can be deemed an employer security.⁴⁶⁴ If voting shares are contributed, ERISA does not require that the voting rights be exercisable by the employees. Therefore, the Trust can create a committee to vote the stock, which can be comprised entirely of directors or officers, thus preventing transfer of control to the employees.⁴⁶⁵

*The author wishes to extend special thanks to Anthony J. Alexander, J.D., University of Akron, for his contribution of this section.

⁴⁶⁰ Act of Sept. 2, 1974, Pub. L. No. 93-406, § 1, 88 Stat. 829.

⁴⁶¹ Statement by Senator Long, as quoted in Hyatt, *Free Distributions of Stock to Employees Are Spurred by a New Tax-Law Provision*, *The Wall Street Journal*, April 29, 1975, at 36, col. 3.

⁴⁶² ERISA § 407(d)(6).

⁴⁶³ Treas. Reg. § 1.401-1(b)(1)(ii).

⁴⁶⁴ See ERISA § 2003(a); INT. REV. CODE OF 1954, § 4975(e)(8).

⁴⁶⁵ Provisions of the Tax Reduction Act of 1975, Act of March 29, 1975, Pub. L. No. 94-12, 94

An ESOP is a plan that uses borrowed funds to finance the purchase of the firm's stock for funding the Trust. An ESOP, although a form of stock bonus plan, is the only variety of such plans which permits the purchase of employer stock with employer guaranteed loans.⁴⁶⁶ This feature, legislatively approved, is the distinction which establishes the uniqueness of ESOPs as compared with other deferred compensation plans and provides the basis for their many uses in corporate finance.

ERISA further classifies ESOPs as defined contribution plans.⁴⁶⁷ In a defined contribution plan, the employer's annual contribution is fixed, usually at a flat dollar amount or at a percentage of compensation, and the amount of an employee's retirement benefit depends on the investment performance of the pension fund. Since the employees' benefit depends, at least in the case of ESOPs, on the performance of the trust, such plans are exempt from the minimum funding standards.⁴⁶⁸ Also, as a defined contribution plan, an ESOP is excluded from the provisions requiring plan termination insurance.⁴⁶⁹

The key to the Employee Stock Ownership Trust is its ability to invest in employer securities. Section 407(a) of ERISA limits the holding of employer securities to 10% of the fair market value of the assets of the plan. However, Section 407(b) exempts eligible individual account plans, which, as defined in Section 407(d)(3), includes employee stock ownership plans. To fully maximize the ESOP financing technique, the trust must not only be able to hold employer securities, but must also have the ability to leverage investments in such securities above the amount contributed by the corporation. Section 404(a)(1) of ERISA imposes responsibilities on fiduciaries to discharge their duties with respect to a plan solely in the interest of participants and beneficiaries for the exclusive purpose or providing benefits to such parties and defraying reasonable expenses of administering the plan. This is commonly referred to as the exclusive benefit rule. It can be satisfied if the acquisition, sale or lease is for adequate consideration and if no commission is charged.⁴⁷⁰ If these conditions are complied with, ESOP financing will be available and the trust can borrow funds and use the proceeds to

89 Stat. 26, and the Trade Act of 1974, Act of January 3, 1975, Pub. L. No. 93-618, 88 Stat. 1978, require the pass through of voting rights to obtain the benefits contained in those Acts.

⁴⁶⁶ See ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(d)(3).

⁴⁶⁷ ERISA § 2003(a), INT. REV. CODE OF 1954, § 4975(e)(7).

⁴⁶⁸ ERISA § 1013(a), INT. REV. CODE OF 1954, § 412(b)(1).

⁴⁶⁹ ERISA § 4021(b).

⁴⁷⁰ *Id.* § 408(e).

purchase employer securities, using such securities as collateral for the loan.⁴⁷¹

Even though an ESOP has the advantage of partially circumventing the fiduciary controls, they must still comply with the provisions of ERISA dealing with vesting and participation,⁴⁷² disclosure,⁴⁷³ and requirements of Section 401 (a) of the Internal Revenue Code.

Contributions to an ESOT are generally made in qualifying employer securities unless cash is contributed to service debts incurred by the trust. A qualifying employer security is defined in Section 2003(e)(8) of ERISA as an employer security which is: "(A) stock or otherwise an equity security, or (B) a bond, debenture, note, or certificate or other evidence of indebtedness" This definition establishes a basis for contributing any type of equity security whether voting, non-voting, common or preferred. Section 415 as amended by Section 2004(a) of ERISA defines the limits on benefits and contributions under qualified plans. Section 415 states that the trust shall not constitute a qualified trust under Section 401(a) if the contribution and other additions with respect to a participant's account is greater than the lesser of \$25,000 or 25 percent of the participant's compensation. The annual addition is computed by the sum of the employer contributions plus forfeitures.⁴⁷⁴ Although contributions may be made within the limits above, the deduction from income for contributions to stock bonus plans may not exceed 15 percent of the compensation paid or accrued during the taxable year to covered employees.⁴⁷⁵ However, any excess contributions may be carried forward to subsequent years when contributions are less than the 15 percent limit.

Since the corporation will be attempting to deduct the value of the securities contributed, it is essential that a proper valuation be assigned to the securities. If too low a value is placed on the employer securities, the Service may claim that the plan is not qualified because it is not for the exclusive benefit of the employees.⁴⁷⁶ On the other hand, placing too high a value on the employer securities may merely result in the corporation claiming an excessive deduction. The valuation method chosen is determina-

⁴⁷¹ *Id.* § 408(b)(3).

⁴⁷² ERISA, Tit. I, subtit. B, part 2.

⁴⁷³ *Id.* part 1.

⁴⁷⁴ ERISA § 2004(a), INT. REV. CODE OF 1954, § 415(c)(2). If employee contributions are made to the trust, the annual addition also includes the lesser of: (i) the amount of the employee contributions in excess of six percent of his compensation, or (ii) one-half of the employee contributions.

⁴⁷⁵ INT. REV. CODE OF 1954, § 404(a)(3)(A).

⁴⁷⁶ ERISA § 408(e).

tive of various extrinsic factors and, as such, should be selected at the outset of the plan and consistently applied for purposes of both contributions and distributions. An appraisal may be required, since each share may not have a value equivalent to those shares publicly traded because the shares may be unregistered in accordance with securities laws, thus not freely marketable, or the distribution may be so excessive as to have an adverse effect on financial indicators, thus depressing the market value.

An ESOP has the advantage of making capital financing deductible. By using an ESOP as the vehicle for obtaining the funds to finance corporate growth, the corporation can use pre-tax deductible dollars to repay the loan. In operation, the ESOT rather than the corporation would borrow the necessary funds, with the note being guaranteed by the corporation. The ESOT would then use such funds to purchase additional shares from the corporation. The shares received by the ESOT would be pledged as collateral for the loan. Thereafter, the corporation would make cash contributions to the trust equal to the repayment schedule for the note. These contributions are deductible by the corporation and are received tax-free by the trust.⁴⁷⁷ For example, assume that a corporation which has an effective tax rate of 50% requires \$2,000,000 for an expansion program.⁴⁷⁸ The ESOT would borrow such funds from the bank and purchase \$2,000,000 worth of shares from the corporation. The corporation would then make cash contributions to the ESOT sufficient to amortize the debt. Since the contributions would be tax deductible, the corporation could service the debt by generating only \$2,000,000 of corporate earnings as opposed to \$4,000,000, if normal financing channels are utilized. The corporation has increased its net cash flow over the period of the loan by \$2,000,000 because by using an ESOP the principal becomes tax deductible rather than merely the interest.

Cash flow will also be increased through the annual contribution of stock to the ESOT. This is true because, via an ESOP, the corporation receives the ultimate tax deduction which involves no cash outlay. Since contributions to an ESOT are not contingent upon profits, as is the case of profit-sharing plans, the corporation may be able to generate a net operating loss which can be carried back three years and forward five years.⁴⁷⁹

The Tax Reduction Act of 1975 introduces a new tax concept by granting an additional one percent investment tax credit to a corporate

⁴⁷⁷ See INT. REV. CODE OF 1954, § 503.

⁴⁷⁸ The loan would only be limited by the amount of available private capital and the ability of the corporation to service the loan.

⁴⁷⁹ INT. REV. CODE OF 1954, § 172.

employer on the condition that equivalent benefits are provided to employees.⁴⁸⁰ Specifically, a corporation may elect to increase its investment tax credit from 10 percent to 11 percent if it agrees to transfer employer securities into an ESOP.⁴⁸¹ The securities transferred must have a value equal to the increase in the investment credit, *i.e.*, one percent of the employer's qualified investment for the year.⁴⁸² However, the employer will not receive a tax deduction for the amounts contributed to an ESOP to the extent the transfers are pursuant to the investment credit election. To qualify for the additional one percent investment credit, the plan must provide that the participant's rights to the securities are nonforfeitable upon allocation to his account at each plan year's end and that the employee can designate how the stock is to be voted.⁴⁸³

The Trade Act of 1974 provides for a \$500,000,000 United States Government fund for backing loans to businesses in "trade impacted areas," that is, in communities which might be adversely affected by imports from abroad.⁴⁸⁴ Section 273(f)(1) of the Act states that preference shall be given to a corporation which agrees that 25 percent of the principal amount of the loan is paid by the lender to an ESOT, "maintained by the recipient corporation, by a parent or subsidiary of such corporation, or by several corporations including the recipient corporations" The Act further states that the amount of the loan to the qualified trust will be used to purchase qualified employer securities, and that the ESOT will service principal and interest out of amounts contributed to the Trust by the recipient corporation.

In effect, the Trade Act of 1974 permits not only preferential treatment to those companies which institute an ESOT, but further allows the loan to the ESOT to be serviced with pre-tax dollars. The government, therefore, pays part of the principal and interest on the loan which it backs. However, as in the case of the Tax Reduction Act of 1975, the securities must be common voting stock which is voted by the participants when allocated to their individual accounts.⁴⁸⁵

Since the regulations dealing with Employee Stock Ownership Plans have not yet been promulgated, determination as to what the plan must specifically provide is unclear. However, if one views the Trade Act of 1974 and the Tax Reduction Act of 1975 as indicators of Government theories

⁴⁸⁰ Act of March 29, 1975, Pub. L. No. 94-12, 89 Stat. 26.

⁴⁸¹ *Id.* § 301(a)(1)(B).

⁴⁸² *Id.* § 301(d)(6).

⁴⁸³ *Id.* § 301(d)(5).

⁴⁸⁴ Act of January 3, 1975, Pub. L. No. 93-618, § 273(g), 88 Stat. 1978.

⁴⁸⁵ *Id.* § 273(f)(5)(c).

on the makeup of ESOPs, it appears that the corporation through the ESOP must provide for a flow-through of voting rights and possibly immediate vesting. Much of the present discussion has considered that these items need not be present to qualify the Trust, however the regulations may construe what appears to be allowed by ERISA narrowly, so that qualifying employer securities can be only voting securities and such voting rights must be passed through to the participants.

When the stock is eventually distributed to the employee, a portion of the distribution may be subject to taxation. There are basically two types of distributions: (1) periodic, with payments from the participant's account being made in installments exceeding one taxable year; and, (2) lump sum, with the participant's account being distributed entirely within one year. If the periodic method of distribution from the ESOT is elected, Section 402(a) provides that the employee would be taxed on the distribution under Section 72 which provides that the value of the stock distributed in excess of the amount contributed by the employee is ordinary income. The distribution may be taxed as a lump sum if the entire interest is distributed within one taxable year,⁴⁸⁶ and the distribution arises from the employee's disability, death, attainment of age 59½ or older, or termination of service,⁴⁸⁷ and the employee has participated in the plan for at least five years.⁴⁸⁸

The two major tax advantages associated with the lump sum method are that a portion of the distribution may be taxed as a capital gain and taxation of the unrealized appreciation is deferred. However, the unrealized appreciation is excluded from the employee's basis in the stock, but on the sale of such stock, the realization of the appreciation is treated as a capital gain no matter how long the stock is held by the employee.⁴⁸⁹ If the gain on the sale of such stock exceeds the unrealized appreciation at the time of distribution, the excess is treated as short-term or long-term gain depending upon whether the employee held the securities the requisite months from the date of distribution.⁴⁹⁰ If the employee dies after receiving the lump sum distribution but before disposing of the stock, the unrealized appreciation will not be accorded a stepped-up basis under Section 1014. In Revenue Ruling 75-125,⁴⁹¹ the Service concluded that the "net unrealized appreciation constitutes a right to receive income in respect of a decedent as provided

⁴⁸⁶ INT. REV. CODE OF 1954, § 402(e)(4)(A).

⁴⁸⁷ *Id.*

⁴⁸⁸ *Id.* § 402(e)(4)(H). For a detailed discussion of calculation methods see Briner, *Federal Income Tax Developments: 1974*, 8 AKRON L. REV. 206, 294 (1975).

⁴⁸⁹ Treas. Reg. § 1.402(2)-1(b)(1)(i).

⁴⁹⁰ *Id.*

⁴⁹¹ Rev. Rul. 75-125, 1975 INT. REV. BULL. No. 15, at 13.

under Section 691(a).” As income in respect of a decedent, the unrealized appreciation would become taxable to the recipient when distributed from the estate, however it would retain its long-term capital gain character. Such recipient would also receive a deduction under Section 691(c) for that portion of the federal estate tax attributable to the amount of the net unrealized appreciation included in the decedent’s estate. Under Section 2039(c) and Section 2517, if the employee dies before retirement or before distribution of his benefits, his interest would not be subject to either federal estate or gift tax, except to the extent of contributions made by the employee, provided the beneficiary is other than the employee’s executor or estate.

An ESOP is probably the most sophisticated method of providing employee benefits. It is unique not only in application, but also in the magnitude of benefits such plans provide. ESOP is the employee benefit and corporate financing plan of the future and should be viewed by corporate planners as providing a means for both at the least present cost. The most serious obstacle in adopting this concept is the uncertainty as to how the Treasury regulations will be promulgated. Many tax advisors believe it is too risky to adopt a plan of this complexity without established guidelines, however the versatility of ESOP should not be overlooked for current and future planning.

11.00 Corporations

11.01 Stockholder Approval Requirement for Qualifying Employee Stock Option Plans

Section 421 provides that no income will be recognized when an employee acquires his employer’s stock at discount through exercise of his employee stock option rights, where the option is qualified pursuant to Section 422(b)(1). A qualified stock option is one granted pursuant to a plan which “is approved by the stockholders of the granting corporation within twelve months before or after the date such plan is adopted”⁴⁹² Illuminating the phrase “approved by the stockholders”, Regulation 1.422(b)(1) states:

The approval of the stockholders . . . must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation, voting in person or by proxy at a duly held stockholders’ meeting.⁴⁹³

Applying the above guideline, Revenue Ruling 75-256⁴⁹⁴ determined

⁴⁹² INT. REV. CODE OF 1954, § 422(b)(1).

⁴⁹³ Treas. Reg. § 1.422(b)(1).

⁴⁹⁴ Rev. Rul. 75-256, 1975 INT. REV. BULL. No. 27, at 18.

that a plan of X Corporation did not qualify, since the plan was not approved by stockholders owning a total majority of the voting stock of the corporation. Approval by 80 percent of the stockholders voting in person or by proxy at a stockholders' meeting was not sufficient for compliance with Regulation 1.422(b)(1) where only 40 percent of the outstanding stock ownership was represented at such meeting. In effect, the plan was approved by only 32 percent of the corporation's ownership interests, therefore, the approval failed to meet requirements of Regulation 1.422(b)(1).

In supporting this strict construction of Section 422, the Commissioner stated that these guidelines were needed to protect the stockholders' equity interest in their corporation.⁴⁹⁵ It should be noted that Revenue Ruling 75-256 will not be given retroactive effect; it will apply only to plans approved after July 7, 1976. However, it must be noted that the ruling will not abrogate approval requirements in excess of 50 percent established by state law or by corporate charters and bylaws.⁴⁹⁶

11.02 Corporate Reorganization—Non Recognition Provisions

Section 354(a)(1) provides that no gain or loss will be recognized if stock or securities in a corporation which is party to a reorganization, pursuant to a reorganization plan are exchanged solely for the stock or securities in such corporation or in another corporation also a party to the reorganization. Section 368(a)(1)(B) defines "reorganization" to include the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation.

In Revenue Ruling 75-94,⁴⁹⁷ Corporation A desired to acquire control of Corporation B by exchanging some of its voting stock for all the outstanding stock of the latter. A valuation of \$1,000 was placed on the outstanding stock of Corporation B. The shareholders of Corporation B were willing to exchange their stock for voting stock of Corporation A, if such stock was also valued at \$1,000. Relying on Corporation A's representations, that its stock was presently earning \$6.00 per share, the A shares, having a supposed value of \$1,000, were exchanged for B shares having the same value. This exchange was consummated in 1973 and the shareholders for each corporation received Section 354(a)(1) non-recognition treatment.

Subsequently, former shareholders of Corporation A discovered that improper accounting practices of Corporation B had inflated its earnings per share figures, which led the former Corporation B shareholders to

⁴⁹⁵ *Id.*, citing H. R. REP. No. 749, 88th Cong. 1st Sess. 65 (1963).

⁴⁹⁶ Rev. Rul. 75-256, 1975 INT. REV. BULL. No. 27, at 18.

⁴⁹⁷ Rev. Rul. 75-94, 1975 INT. REV. BULL. No. 27, at 11.

overvalue its shares. Within a year after the initial Section 368(a)(1)(B) reorganization, an agreement was reached whereby former Corporation B shareholders were to receive additional shares of Corporation A to render the exchange equal.

The question presented to the IRS was whether the additional shares received would be entitled to Section 354(a)(1) non-recognition treatment. In answering, the IRS relied on Treasury Regulation 1.368-2. The test established by Regulation 1.368-2 states that non-recognition is limited to exchanges or distributions directly connected to the relevant Section 368(a) reorganization.

Thus, in Revenue Ruling 75-94, the subsequent distributions were qualified as part of the original Section 368(a) plan of reorganization based on an exchange of shares of equal value and were held to merely fulfill the terms of the original plan.

11.03 Applicability of Personal Holding Company Tax to Professional Corporation

Sections 541 through 547 of the Code provide that in addition to other income taxes, an additional 70 percent tax shall be assessed against undistributed personal holding company income. Section 543(a)(7) establishes that amounts received under personal service contracts shall be considered personal holding company income if someone other than the corporation has the right to designate who is to perform the services and the individual performing the service owns at least 25 percent of the corporation stock.

Revenue Ruling 75-67⁴⁹⁸ was issued to clarify the scope of Section 543(a)(7). It establishes that a physician, who is an 80 percent stockholder of a professional corporation as well as its only practicing physician, is not subject to the personal holding company tax when there is no specification by the patient served regarding who is to perform the services and when the services rendered are not so unique that substitution of another physician is not practicable. This ruling resolves a potentially troublesome question in the area of professional corporations and seems applicable to legal corporations.

11.04 Valuation of Corporate Distribution

The Commissioner, committed to non-acquiescence regarding the Sixth Circuit 1965 decision in *H. Wetter Manufacturing Co. v. United States*,⁴⁹⁹

⁴⁹⁸ Rev. Rul. 75-67, 1975 INT. REV. BULL. No. 9, at 7.

⁴⁹⁹ 458 F.2d 1033 (6th Cir. 1972).

added the case to the IRS prime issue list. In *Wetter*, a Section 542 personal holding company attempted to adjust its Section 545 personal holding company income by taking a dividend deduction authorized by Section 454(a). The controversy centered over the valuation of such deduction. The company distributed the capital stock of Texaco, Inc., which had a basis to the taxpayer of \$2,000 and a fair market value of \$38,820; the taxpayer reduced his personal holding company income by the latter amount. The Commissioner, relying on Regulation 1.562-1(a),⁵⁰⁰ declared that the amount deducted for a dividend distribution must be limited to the adjusted basis of the stock in the hands of the distributing corporation. The taxpayer contended the opposite language in Section 301(b)(1)(A), which provides that "the amount of any distribution shall be . . . the amount of money received, plus the fair market value of the property received," controlled the conflicting language in the regulations.

Although recognizing the direct contradiction between the Code and the Regulations, the Commissioner contended that the latter should control since they correctly embody the congressional intent and history behind the Personal Holding Company sections.⁵⁰¹ The Sixth Circuit disagreed, analyzing the language of Sections 301, 545, 561, 562 and 316 as supporting the taxpayer's contention and further stated that extrinsic aids to construction such as legislative intent and history would be used to solve, not create, ambiguity and would not be applied to uphold regulations which are contrary to express statutory language.⁵⁰²

11.05 Capital Gains Treatment on Inter-Corporate Sales of Depreciable Property

In *Miller v. Commissioner*,⁵⁰³ the Ninth Circuit was confronted with the seldom litigated issue of whether Section 1239(a)(2) precluded capital gains treatment when an 80 percent controlled corporation⁵⁰⁴ sells Section 1231 assets to another corporation controlled by the same individual. Section 1239 provides that the capital gain treatment of Section 1231 is not available, where a direct or indirect sale or exchange is made between an individual and any corporation whose outstanding stock is more than 80 percent owned by such individual.

Although the Commissioner contended that a sale between two

⁵⁰⁰ Treas. Reg. 1.562-1(a), reads as follows:

If a dividend is paid in property (rather than money), the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution.

⁵⁰¹ INT. REV. CODE OF 1954, § 541-47.

⁵⁰² 458 F.2d at 1034, 1035.

⁵⁰³ 510 F.2d 230 (9th Cir. 1975).

⁵⁰⁴ INT. REV. CODE OF 1954, § 1239(a)(2).

controlled corporations constituted an indirect sale between the taxpayer and one of the corporations since the sole proceeds eventually inured to the taxpayers benefit, the Ninth Circuit rejected this argument by refusing to characterize one of the corporations as a straw man. It declared that Section 1239 did not affect this transaction since a sale between two controlled corporations was not specified in either the Code or the Regulations. It is submitted that the court's refusal to characterize one of the corporations as a straw man, and thus deem the transaction an indirect sale, was inappropriate, since an 80 percent owned corporation, by analogy, is at least as controlled as a spouse in Section 1231 inter-spousal transactions, which are proscribed by Section 1239(a)(1). It should be noted that *Miller* is contrary to Revenue Ruling 69-109 in which it was declared that Section 1239 encompassed the controlled corporation situation.⁵⁰⁵

11.06 Spin Offs and Split Ups from a Single Business

Section 355 enables corporations to reorganize without recognition of gain or loss by their shareholders. Since 1961,⁵⁰⁶ it has been clearly established that this section allows a corporation conducting a single business to "split-up or spin-off"⁵⁰⁷ into two or more separate corporations without tax recognition.⁵⁰⁸ However, the Commissioner has long relied on Treasury Regulation 1.355-1(a) in contending that to qualify for a tax free divisive reorganization, it must appear that the trade or business of the new corporation must have been actively conducted as a separate business of the parent corporation throughout the five-year period preceding the reorganization.⁵⁰⁹ This interpretation of Treasury Regulation 1.355-1(a) has been dismissed as invalid.⁵¹⁰ For example, in *Edmund P. Coady*,⁵¹¹ the Tax Court held that Section 355 non-recognition treatment was available where two 50 percent shareholders of a construction company divided its assets to form two separate construction companies, with each taxpayer being the sole owner.

Against this background of consistent refusals to apply the multiple-business requirement of Treasury Regulation 1.355-1(a), the Commissioner announced in advanced Revenue Ruling 75-160⁵¹² that he would follow

⁵⁰⁵ Rev. Rul. 69-109, 1969-1 CUM. BULL. 202.

⁵⁰⁶ *Edmund P. Coady*, 33 T. C. 771 (1960).

⁵⁰⁷ See J. Chommie, FEDERAL INCOME TAXATION 225, at 677 (2nd ed. 1973).

⁵⁰⁸ E.g., *Rafferty v. Comm'r*, 452 F.2d 767 (1st Cir. 1971); *United States v. Marrett*, 433 F.2d 1064 (5th Cir. 1963); *Edmund P. Coady*, 33 T.C. 771 (1960).

⁵⁰⁹ 433 F.2d 1064.

⁵¹⁰ See cases cited in note 508 *supra*.

⁵¹¹ 33 T. C. 771.

⁵¹² Rev. Rul. 75-160, 1975 INT. REV. BULL. No. 18, at 7.

Coady, United States v. Marrett,⁵¹³ and *Rafferty v. Commissioner*,⁵¹⁴ until publication of revised regulations for Section 355.

However, the IRS example promulgated in this ruling does not closely resemble *Coady* or the others. Instead of showing a split-up of a single business, the IRS example demonstrates a spin-off of two controlled integrated food manufacturing and retailing corporations from a parent furniture corporation. As a result, this example obfuscates the Commissioner's intention as to his forthcoming revised Regulations, since the factual situation as presented has never been a problem under Section 355 or Treasury Regulation 1.355-1(a).

11.07 Allocation of Income and Deductions Among Controlled Corporations

Section 482 provides that the IRS may allocate gross income, deductions, or credits among two or more corporations or other business associations if such entities are owned or controlled directly or indirectly by the same interest and reallocation is necessary to prevent evasion of taxes or to clearly reflect the income of such corporations.

Where one of a group of controlled corporations made interest-free loans to the other three, the Commissioner, in *Cayuga Service, Inc.*,⁵¹⁵ employed Section 482 to charge taxpayer with the interest income and to assess the additional tax which would have resulted if the loan had been made by two firms bargaining at arm's length.⁵¹⁶ The Tax Court reluctantly agreed with the Commissioner's assessment even though the interest-free loans had not produced any income for the other corporations which could be traced back and allocated to *Cayuga*. The Tax Court abandoned the tracing test, which it had supported in *Huber Homes, Inc.*⁵¹⁷ and *Kerry Investment Co.*,⁵¹⁸ as an appeal would be to the Second Circuit,⁵¹⁹ which had already adopted the rule set by the Tenth Circuit in *Jack E. Golsen*,⁵²⁰ that Section 482 did not require income production for allocation purposes. The *Golsen* court ruled that income tracing was irrelevant to the question of whether income or deductions had been shifted among controlled corporations to lower their collective tax bill.

⁵¹³ 433 F.2d 1064.

⁵¹⁴ 452 F.2d 767.

⁵¹⁵ 44 P-H TAX CT. MEM. ¶ 75,004 (Jan. 13, 1975).

⁵¹⁶ See *Kerry Investment Co. v. Comm'r*, 500 F.2d 108 (9th Cir. 1974).

⁵¹⁷ 55 T. C. 598 (1971).

⁵¹⁸ 58 T. C. 479 (1972).

⁵¹⁹ *B. Forman Company v. Comm'r*, 453 F.2d 1144 (2nd Cir. 1972).

⁵²⁰ *Jack E. Golsen*, 54 T.C. 742 (1970), *affd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

Although the Commissioner's position has been attacked as a creation of non-existent income,⁵²¹ the Commissioner's allocation here is appropriate since he puts each corporation in the tax position it would have occupied had it not been involved in these non-arm's length transactions. *Cayuga* is especially appropriate since, in addition to not charging and reporting interest income on the loan, the corporation took an interest deduction for sums it was forced to borrow on the basis that the loans to the other controlled corporations depleted operating capital.

11.08 Accumulated Earnings Tax

Sections 531 through 537 impose the accumulated earnings tax on corporate profits and earnings which are permitted to accumulate instead of being distributed as dividends. Section 531 imposes the tax on accumulated taxable income; Section 535 defines accumulated taxable income as taxable income reduced by the adjustments provided in Section 535(b). Section 532(a) imposes the Section 531 tax on any corporation which is, "formed . . . for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed."

In the 1974 case of *GPD, Inc. v. Commissioner*,⁵²² the accumulated earnings tax was imposed on GPD even though its retained earnings had actually decreased in the tax year in which it was assessed. Although GPD had made a substantial profit in 1968, it expended all its current income and a portion of its retained earnings to redeem stock with which it had made a charitable contribution in past years. Since stock redemptions are not an adjustment from taxable income provided for under Section 535(b), the Commissioner assessed the additional accumulated earnings tax of 27½ percent on the first \$100,000 of 1968 accumulated taxable income, and 38½ percent of 1968 accumulated taxable income in excess of \$100,000.

The taxpayer argued that the Section 532 language, "by permitting earnings and profits to accumulate," used the present tense and therefore, a positive accumulation of earnings in the current year was a condition precedent to triggering the accumulated earnings tax.⁵²³ The Sixth Circuit negated that contention by adopting the *reductio ad absurdum* argument of the district court in *Ostendorf-Morris Co. v. United States*.⁵²⁴ In a similar situation, that court noted that under the taxpayer's view, none of the accumulated taxable income could be taxed if all of the current earnings

⁵²¹ See *Kerry Investment Co.*, 58 T. C. 479 (1972); *Huber Homes Inc.*, 55 T. C. 598 (1971).

⁵²² 508 F.2d 1076 (6th Cir. 1974).

⁵²³ *Id.* at 1080, 1081.

⁵²⁴ 26 Am. Fed. Tax R. 2d 70-5369 (N. D. Ohio 1968).

were distributed; however, if one penny was not distributed, all of the accumulated taxable income could be taxed. The court was quite succinct in stating, "Certainly, Congress never intended such an absurd result."⁵²⁵ The district court further reasoned that in determining the reasonableness of earnings accumulations, Sections 531 through 537 focused on both past and present corporate needs and accumulations. The *GPD* decision seems sound; otherwise, corporate liability for the accumulated earnings tax would be exclusively controlled by its present earnings retention policy.

Prior to 1974, Section 531 accumulated earnings tax had only once been assessed against a publicly held corporation.⁵²⁶ However, in November 1974, the Ninth Circuit in *Golconda Mining Corp. v. Commissioner*⁵²⁷ was faced with a case where the Commissioner had assessed the accumulated earnings on a publicly held corporation which had from 1,500 to 2,000 stockholders during the relevant tax period and was traded on three exchanges. Additionally, the most prominent shareholder group controlled only 12 percent of the corporation's stock.

Although Sections 531 through 537 do not expressly limit the tax's application to privately owned corporations, the Ninth Circuit reversed the Tax Court's decision,⁵²⁸ upholding the Commissioner's assessment against *Golconda*. The Tax Court had looked to the language of the accumulated earnings provisions⁵²⁹ and concluded that the sections were applicable to any corporation irrespective of the nature of its ownership. In reversing, the Ninth Circuit relied on congressional acknowledgment and apparent approval of the long-standing practice of limiting the tax to private corporations. The circuit court also logically reasoned, that when corporate control and ownership were so diversified, it was unreasonable to conclude that the stockholders could collectively institute and adhere to a plan whereby earnings and profits were permitted to accumulate for the purpose of avoiding the income tax.⁵³⁰ The only other case in which the tax has been assessed against a publicly held corporation was *Trico Products v. Commissioner*,⁵³¹ in which the Second Circuit upheld the Commissioner's action. The *Golconda* court distinguished *Trico*, on the basis that in *Trico* a small group of stockholders owned 62-68 percent of the stock of the corporation.⁵³² Thus, unlike

⁵²⁵ *Id.*

⁵²⁶ *Trico Products Corp. v. Comm'r.*, 137 F.2d 424 (2nd Cir. 1943).

⁵²⁷ 507 F.2d 594 (9th Cir. 1974).

⁵²⁸ 58 T. C. 139 (1974).

⁵²⁹ INT. REV. CODE OF 1954, § 123, 532(a).

⁵³⁰ 507 F.2d 594, at 597.

⁵³¹ 137 F.2d 424.

⁵³² 507 F.2d 594, at 596.

the *Golconda* shareholders, those in *Trico* were better able to dictate corporate policy so that earnings and profits could be accumulated in a tax avoidance effort. In Treasury Information Release 1355,⁵³³ the Commissioner has announced that it will not acquiesce to the *Golconda* decision.

In *Ivan Allen Co. v. United States*,⁵³⁴ the Supreme Court held that when determining what assets are available for the reasonable needs of the business, and hence what accumulations are unreasonable, the marketable securities owned by a company will be valued at "net liquidation value" rather than the traditional cost valuation accorded to such assets. Net liquidation value here is defined as market value less costs of selling and taxes. Thus, marketable securities are adjusted upwards for appreciation in "reasonable accumulation" determinations. The Supreme Court opted for this less conservative asset valuation because it felt that this measure was a more accurate indication of the company's position.

The taxpayer in *Allen* argued that this valuation would have disruptive effects on corporate finances, since distribution decisions would have to be made on the basis of inflated and constantly fluctuating security values.⁵³⁵ In dissent, Justices Powell, Douglas and Stewart agreed with the taxpayer's contention that the company might find itself in a perilous financial position when making distributions on the basis of the volatile securities market. Additionally, the dissenters pointed out that the Court's net liquidation valuation of "readily-marketable securities" created the problem of determining what was readily marketable.⁵³⁶

Because the court imposes this net liquidation valuation only as to readily-marketable securities, it may be possible to circumvent this decision by investing in non-liquid assets.

11.09 Corporate Redemptions—Family Attribution

Section 302 allows stockholders to treat corporate distributions received for redemption of their stock as sums received in exchange for the stock which receive capital gains treatment rather than as dividends taxed at ordinary income rates. Instances in which this preferred treatment is permitted include: (1) redemptions which are not essentially equivalent to a dividend;⁵³⁷ and, (2) redemptions which completely terminate a shareholder's interest for ten years.⁵³⁸ In determining whether the redemption is

⁵³³ T. I. R. 1355, 6 P-H 1975 FED. TAXES ¶ 55,150.

⁵³⁴ 95 S. Ct. 2501 (1975).

⁵³⁵ *Id.* at 2510.

⁵³⁶ *Id.* at 2511.

⁵³⁷ INT. REV. CODE OF 1954, § 302(b)(1).

⁵³⁸ INT. REV. CODE OF 1954, § 302(b)(3), (c)(2).

not essentially equivalent to a dividend the Supreme Court in *United States v. Davis*⁵³⁹ established that "redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."⁵⁴⁰

In ascertaining what a shareholder's proportionate interest is, Section 302(c)(1) invokes the constructive ownership rules of Section 318, with the family attribution rules of Section 318(a)(1) being triggered most often.

In *Robin Haft Trust v. Commissioner*,⁵⁴¹ the Commissioner and the Tax Court mechanically applied the family attribution rules to characterize a redemption as substantially equivalent to a dividend. In that case, Marcia Foster and Burt Haft were married in 1956. Marcia's father bought 100,000 shares in Burt's corporation and made gifts of the stock to his grandchildren in the amount of 25,000 shares given to each of four trusts he established for them. Subsequently Marcia and Burt were divorced and Marcia moved to New York with the children while Burt remained in Florida. Burt's corporation redeemed the children's shares and characterized the distribution as a Section 302(b)(1) redemption which should be accorded capital gains treatment. The Commissioner and the Tax Court disagreed, reasoning that since Burt was still the owner of 133,000 shares, the children should be attributed with the shares of their father. Consequently, the proportionate ownership interest of each child after the redemption was greater than their interest prior to redemption. As the redemption did not result in "a meaningful reduction in the shareholder's proportionate interest" as required by *United States v. Davis*,⁵⁴² the taxpayers were precluded from availing themselves of Section 302(b)(1).

However, the Court of Appeals for the First Circuit questioned this mechanical application of the family attribution rules, as asserted by the Commissioner, where the family was no longer the cohesive easily controlled unit upon which the family attribution rules were predicated. Noting *Davis'* focus on "a change in the relative economic interests or rights of the stockholders,"⁵⁴³ the *Haft* court declared:

This language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules.⁵⁴⁴

⁵³⁹ 397 U.S. 301 (1970).

⁵⁴⁰ *Id.* at 313.

⁵⁴¹ 510 F.2d 43 (1st Cir. 1975).

⁵⁴² *Id.* at 47, citing *United States v. Davis*, 397 U.S. 301 (1970).

⁵⁴³ 397 U.S. 301, at 313.

⁵⁴⁴ 510 F.2d 43, at 48.

The court therefore remanded the case to the Tax Court for a determination as to whether this family disunity rendered application of the family attribution rules inappropriate.

In *Haft*, it should be noted that the children could have received capital gains treatment under the complete termination provisions of Section 302(b)(3), but were barred because they failed to file a Section 302(c)(2) agreement with the Commissioner.

The IRS has promulgated Revenue Ruling 75-2,⁵⁴⁵ creating a dilemma for stockholders reacquiring an interest in the corporation after receiving capital gains treatment under Section 302(b)(3). The ruling states that Section 302(c)(2) precludes application of the family attribution rules if the stockholder does not reacquire stock for ten years except by bequest or inheritance, and does not become an officer, director or employee for the same period.

Revenue Ruling 72-380⁵⁴⁶ established that a stockholder who was allowed capital gains treatment under Section 302(b)(3) would not be subject to reassessment even if he is bequeathed controlling ownership of the corporation under his father's will and becomes executor of his father's estate which owns 100 percent of the corporation. Although Section 302(c)(2) does not specifically exclude executors as it does with legatees of the stock, the Revenue Ruling reasons that the executor's interest is so insignificant when compared to the legatee's interest as an owner that the executor should not be penalized for the acquisition of his tangential interest.

However, Revenue Ruling 75-2,⁵⁴⁷ states that if this same Section 302(b)(3) ex-stockholder also becomes an employee, director or officer of the corporation, he would be subject to reassessment, as such positions are specifically proscribed by Section 302(c)(2)(A)(i). This presents an irritating problem for a legatee-stockholder since he is precluded from operating his corporation for whatever remains of the 10 year period even if he owns 100 percent of the corporation. It is submitted that this is an unrealistic and unreasonable position since a 100 percent shareholder should be permitted to directly manage his firm since his sole owner's status enables him to attain the same result indirectly. Just as another's death frees the taxpayer from penalty in reacquisition of stock ownership, no penalty should accrue when death of the testator results in the legatee's management of the firm.

⁵⁴⁵ Rev. Rul. 75-2, 1975 INT. REV. BULL. No. 1, at 11.

⁵⁴⁶ Rev. Rul. 72-380, 1972-2 CUM. BULL. 201.

⁵⁴⁷ Rev. Rul. 75-2, 1975 INT. REV. BULL. No. 1, at 11.

11.10 Corporate Redemptions—Deceased Employee's Stock

In two previous cases on point, the Ninth Circuit⁵⁴⁸ and the District Court for the Eastern District of Virginia⁵⁴⁹ found that corporate death redemptions of employee stock in excess of the agreed redemption rate were excludable gifts as the corporation had no legal obligation to make such excess payments. In contrast, the Fifth Circuit in *Jensen v. United States*,⁵⁵⁰ disagreed, declaring that the excess payments were the product of the employer's interest in making its employee stock option plan more attractive rather than emanating from a detached and disinterested generosity, and for that reason the payments were not excludable as gifts.

In *Jensen*, the taxpayer retired after twenty-five years with Graybar Electric. Upon her death, the company exercised its right to redeem her stock at par and, under its special death benefits plan, to pay her a sum equivalent to dividends which would have been paid on her stock over the next five years. Due to the long history of the death benefit plan being automatically paid upon redemption, the court held it had become almost adjunctive to the employee stock option plan.

In determining the issue of whether there was a gift, the *Jensen* court noted this long history of payment and stated that the excess payments were clearly a sweetener to the stock plan. As such, the benefits were intended to benefit the corporation in assuring a ready source of capital by making the plan more attractive. The court relied on the gift test set down in the landmark case of *Commissioner v. Duberstein*,⁵⁵¹ which found that there was no gift where "the payment proceeds . . . from the incentive of anticipated benefit . . ."⁵⁵² *Duberstein* established that the critical factor in the determination of a gift vel non was the transferor's motive. *Jensen* again borrowed from *Duberstein* in stating that the company's payment did not meet the requirement that a "gift . . . proceeds from detached and disinterested generosity."⁵⁵³ According to the Fifth Circuit, the district court below had placed undue reliance on the fact that Graybar had no legal obligation to make such special death benefit payments.

11.11 Multiple Stock Redemptions to Pay Death Tax

Section 303 provides that a corporate distribution in redemption of all or part of its stock which is included in the gross estate of the decedent shall

⁵⁴⁸ *Harper v. United States*, 454 F.2d 222 (9th Cir. 1971).

⁵⁴⁹ *Pearson v. United States*, 33 Am. Fed. Tax R. 2d 74-1176 (E. D. Va. 1974).

⁵⁵⁰ 511 F.2d 265 (5th Cir. 1975).

⁵⁵¹ 363 U.S. 278 (1960).

⁵⁵² *Id.* at 285.

⁵⁵³ *Id.* at 286.

be treated as a distribution in payment for such stock if the conditions of Section 303(b) are met. To receive capital gains treatment under this section, 35 percent of the gross estate or 50 percent of the taxable estate must consist of stock of the redeeming corporation.⁵⁵⁴ When an estate includes the stock of two or more corporations, such corporations are considered as a single entity for the purposes of Section 303(b)(2)(a) if more than 75 percent of the outstanding stock of each corporation is included in the estate. Additionally, the total amount that can be given capital gains treatment under Section 303 cannot exceed the sum of estate, inheritance, legacy, and succession taxes plus funeral and administration expenses.

In a situation where more than one Section 303 corporation redeemed its stock from the decedent's estate and the aggregate redemption amount exceeded the total of inheritance and estate taxes plus funeral and administration expenses,⁵⁵⁵ neither the Code nor the Regulations offered any clue as to which redemptions were to be accorded Section 303 capital gains treatment. To clarify this uncertainty, the Treasury promulgated an amendment⁵⁵⁶ to Regulation 1.303(2)(g). Regulation 1.303(2)(g)(1) directs that where more than one qualified⁵⁵⁷ corporation redeems its stock from the decedent's estate and the aggregate redemption exceeds the amount determined by Section 303(a), the amounts received are to be applied against the amount qualifying for preferred treatment in the order in which such amounts were received.

11.12 Valuation of Transferred Securities

In *Bankers Trust Co. v. United States*,⁵⁵⁸ the Commissioner and Court of Claims agreed as to the date of valuation and method of valuation to be applied when calculating a corporation's income or receipt of stock. In 1939, Mesabi Iron Company entered into an agreement with Reserve Mining Co., whereby Reserve Mining would work land owned and controlled by Mesabi and pay Mesabi one third of the net profits for the iron mining operation. In addition, Reserve Mining promised to procure the highest current price known for material of like value in use and for like quantities in making sales and determining profits. The parties set up a board of arbitration to settle disputes.

During the 1950s Reserve Mining failed to share profits with Mesabi in accordance with their agreement. These disputes were followed by years

⁵⁵⁴ INT. REV. CODE OF 1954, § 303(b)(2)(A).

⁵⁵⁵ INT. REV. CODE OF 1954, § 303(a).

⁵⁵⁶ Treas. Reg. 1.303(2)(g).

⁵⁵⁷ INT. REV. CODE OF 1954, § 303(b)(2).

⁵⁵⁸ 36 AM. FED. TAX R. 2d 75-5313 (Ct. Cl. July 11, 1975).

of negotiation and litigation. On February 18, 1960 negotiators reached an agreement under which Mesabi would receive \$400,000 and all of Reserve Mining's stock in Mesabi, totaling 163,570 shares worth \$5,908,966.25 as of February 18, 1960. Reserve Mining requested that the agreement not become effective until approved by a majority of outstanding Mesabi shares not including Reserve's shares. Mesabi stockholders approved the agreement on April 22, 1960 at which time the transferred stock was worth \$12,799,352.50. In filing its 1970 income tax return Mesabi used the February 18, 1960 valuation date to determine its income less a \$4.25 per share "blockage" discount. The Commissioner disallowed the "blockage" discount and determined that the proper value of the stock was its value as of April 22, 1960.

The petitioner argued that *Herbert J. Investment Corp. v. United States*,⁵⁵⁹ which placed the date of valuation of transferred assets at the time of the final settlement, should control. However, the court distinguished *Herbert J. Investment Corp. v. United States* on the rationale that the parties in *Herbert* reached a binding agreement without waiting for ICC approval, and that such approval was merely a condition subsequent to the agreement. On the other hand, in *Bankers* no effort was made to close the agreement until the Mesabi stockholders approved the agreement. The stockholder's approval was treated as a significant condition precedent in effecting a final agreement, rather than a condition subsequent to the agreement as was ICC approval in *Herbert J. Investment Corp.* From the evidence presented, the court concluded Mesabi and Reserve never contemplated that closing of the agreement would or could occur prior to stockholder approval.

To avoid the pitfalls of the *Bankers* case in determining the date of valuation, a taxpayer should pattern the closing of a negotiated agreement in settlement of claims in accordance with *Herbert J. Investment Corp. v. United States*. The negotiated agreement should clearly indicate the value of all items given and received and the valuation date contemplated by the parties, to facilitate evaluation of the items exchanged.

12.00 Subchapter S Corporations

12.01 Creation of Voting Trust

In *Lafayette Distributors, Inc. v. United States*,⁵⁶⁰ the Commissioner had terminated taxpayer's subchapter S election because three stockholders with a combined 50 percent ownership interest in the company had formed a voting trust. The Commissioner contended that because the individuals

⁵⁵⁹ 360 F. Supp. 825 (E. D. Wis. 1973), *aff'd*, 500 F.2d 44 (7th Cir. 1974).

⁵⁶⁰ 36 Am. Fed. Tax R. 2d 75-5479 (W.D. La. 1975).

surrendered their shares and had them reissued in the name of the trustee of the voting trust, the trust, as technical owner of the shares, was not an individual as required by Section 1371(a)(2). In making this assertion, the Commissioner relied on Treasury Regulation 1.1371-1(e) which states: "A corporation in which any shareholder is a . . . trust . . . does not qualify as a small business corporation."

The *Lafayette* court ruled that the regulation was clearly inconsistent with the statute and unreasonable in its application and held that the creation of a voting trust did not terminate taxpayer's Subchapter S election. The court characterized its decision as one based upon substance rather than form, reasoning that the individuals were still the beneficial owners and that they would pay the tax on the corporation's income. The court quoted the following language in Treasury Regulation 1.1371-1(d)(1) in supporting its decision: "Ordinarily, the persons, who would have to include in gross income, dividends distributed with respect to the stock of the corporation, are considered to be the shareholders of the corporation."

Rather than classifying Treasury Regulation 1.1371-1(e) as an exception to the above statement, the court held that voting trusts do not constitute an exception to the general rule that one who is the beneficial owner is also the stockholder for purposes of Section 1371(a)(2).

Although it may seem that the Commissioner could have asserted a Section 1371(a)(4), "more than one class of stock," violation due to the creation of a voting trust, it appears that this issue has already been resolved in favor of the taxpayer.⁵⁶¹

12.02 Retroactive Accounting Changes

Barring fraud or error, a taxpayer can generally assume that once he has been assessed and paid the tax on income resulting from business operations, his tax liability for that period is settled. However, in *Ronnie L. Barber*,⁵⁶² the Tax Court permitted the IRS a 1972 retroactive accounting change, which resulted in increased income and tax on the taxpayer's 1971 return.

Barber had been a minority shareholder in a Subchapter S corporation whose fiscal year ended on April 30, 1971. On the basis of its completed contract accounting method, the corporation passed through an \$11,000 loss to *Barber* who deducted the same on his 1971 return. In June, 1972, the IRS allowed the corporation to file an amended return for the fiscal

⁵⁶¹ See *A & M Furniture & Appliance Co. v. United States*, 19 Am. Fed. Tax R. 2d 1487 (S. D. Ohio 1967).

⁵⁶² 64 T. C. No. 27 (May 29, 1975).

year ending April 30, 1971, in which it allowed the company to change to the percentage of completion accounting method. The result was a net profit for the corporation and a \$5,000 pass through to *Barber*.

The taxpayer contended that he should not be reassessed, since the IRS is given no authority to accept retroactive accounting changes. The Commissioner countered that although there seemed to be no specific grant of authority in this area, his actions were sanctioned by the broad grant of discretion given him to make any adjustments required to clearly reflect a taxpayer's income. The *Barber* court agreed, analogizing the Commissioner's action to his Section 446(b) power to direct present or future accounting methods which clearly reflect income.⁵⁶³ The Tax Court also found support for the IRS position in the fact that there was no specific prohibition of this type of action.⁵⁶⁴

This decision presents a problem for a withdrawing Subchapter S shareholder who wishes to protect himself. Perhaps future shareholders can reach agreements with the corporation for retroactive adjustments of the selling price of shares or procure a warranty against retroactive accounting changes.

12.03 Passive Investment Income

Section 1372(e)(5)(A) provides that the election of a Subchapter S Corporation made under Section 1372(a) shall be terminated if passive investment income constitutes more than 20 percent of such corporation's gross receipts. Section 1372(e)(5)(C) defines passive income as including gross receipts derived from interest.

In *Marshall v. Commissioner*,⁵⁶⁵ over 20 percent of the taxpayer's gross receipts were made up of income derived from financing operations. Applying Section 1372(e)(5) with its inclusion of interest as passive income in Section 1372(e)(5)(A), the Commissioner terminated the taxpayer's Subchapter S status. Marshall contested this action, arguing that since the interest income was earned as a result of the active operations of its small loan department, such interest income was beyond the scope of Section 1372(e)(5) passive income limitations. Following the lead of the Tax Court⁵⁶⁶ and the Eighth Circuit,⁵⁶⁷ the Tenth Circuit agreed with the Commissioner, pointing out that Section 1372(e)(5)(C) specifically enumerates interest as passive income

⁵⁶³ *Id.* at 156.

⁵⁶⁴ *Id.* at 156-57.

⁵⁶⁵ 510 F.2d 259 (10th Cir. 1975).

⁵⁶⁶ 60 T. C. 242 (1973).

⁵⁶⁷ *Zychinski v. Commissioner*, 506 F.2d 637 (8th Cir. 1974).

for purposes of the 20 percent termination rule. The court also declared that the statute made no mention of actively earned Section 1372(e)(5)(C) income.

Further support for the *Marshall* court's holding is found in an analysis of other Code provisions relating to earned income. When differentiating earned income from passive income for the purposes of the Section 1348 maximum tax rate, Section 1348(b)(1) defines earned income as any income which is earned within the meaning of Section 911(b). In turn, Section 911(b) defines earned income as "wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered. . . ."

Thus, interest income must be distinguished from the above sources since it results from use of capital rather than use of one's labor.

12.04 Shareholder's Basis for Loss Pass Through Purposes

Section 1374 provides that a Subchapter S Corporation shareholder may deduct corporate operating losses from his personal income to the extent that such losses do not exceed his adjusted basis in the corporation's stock plus his adjusted basis in any indebtedness running from the corporation to him.⁵⁶⁸

In Revenue Ruling 70-50,⁵⁶⁹ the IRS declared that, in addition to actual indebtedness running directly from the shareholder to the corporation, a shareholder's basis, for loss pass through purposes, also included the amount of any corporate indebtedness to a third party which the shareholder had guaranteed and subsequently paid. Increasing the shareholder's basis in the Subchapter S corporation by the amount the shareholder was forced to pay under his guarantee is quite appropriate because subrogation concepts then permit the shareholder to take the third party's place as a creditor of the corporation.

In Revenue Ruling 75-144,⁵⁷⁰ the Commissioner dealt with a situation in which the shareholder-guarantor substituted a personal note, as opposed to cash, for a corporate note to cover corporate default. Again, applying a subrogation rationale, the Commissioner held that the shareholder had increased his basis even if he was not actually obligated to begin paying off his note until one year later. Although the shareholder had not yet expended any funds, the Commissioner reasoned that by substituting his own note for

⁵⁶⁸ INT. REV. CODE OF 1954, § 1376, establishes the method for determining the adjusted basis in stock or indebtedness.

⁵⁶⁹ Rev. Rul. 70-50, 1970-1 CUM. BULL. 178.

⁵⁷⁰ Rev. Rul. 75-144, 1975 INT. REV. BULL. No. 16, at 19.

that of the corporation, he had performed his guarantor's contract and was subrogated to the position of the corporation's original creditor.

TABLE OF RECENT REVENUE RULINGS

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