August 2015

Federal Income Tax Developments: 1873

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1.00 Income

1.01 Assignment of Income. In United States v. Basye, Permanente, a limited partnership consisting of over 200 partner-physicians, many nonpartner physicians and other employees, entered into a contract with Kaiser Foundation Health Plan, Inc., to provide medical services to the 900,000 participating members of the foundation. Kaiser agreed to compensate the partnership at a rate which was originally $2.60 per month per member plus a payment of 12 cents per month per member to a trust fund which would pay retirement benefits to Permanente's partner and nonpartner physicians upon retirement.

A physician became eligible to participate in the plan after completing two years of continuous service. The trustee maintained separate tentative accounts for each physician and payments from Kaiser were allocated among the accounts based on a formulae which considered age, compensation and length of service. However, the amounts allocated did not vest until the physician attained age 65 following 10 years of continuous service, rendered 15 years of service to Permanente, died or became disabled. If a physician terminated prior to vesting, his account was forfeited and redistributed among the remaining participants of the plan. Forfeiture also resulted if, following retirement, services were rendered to another hospital or health plan or if the doctor refused to render consulting services to a Kaiser health foundation. Also the tentative account could not be transferred or assigned. Upon retirement a retirement income policy was purchased for the physician with the accumulated value of his account.

During the four years in question neither the partnership nor the individual partners reported as income any of the $2 million payments from Kaiser to the trust fund or the $60,000 of interest. The Commissioner assessed a deficiency against each partner based on the value allocated to his tentative account. The partners argued that income did not accrue upon allocation by the trust due to the substantial risk of forfeiture and that income should be realized only upon receipt. The Ninth Circuit, relying on Commissioner v. LoBue, determined the payments conferred no immediate benefit upon the partnership or partners because of the risk of forfeiture and that the partnership did not have the right to receive the payments.

The Supreme Court, in reversing the Ninth Circuit relied upon two basic principles of income taxation:

[F]irst, that income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of

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3 Basye v. United States, 450 F.2d 109 (9th Cir. 1971).
that income and, second, that partners are taxable on their distributive or proportionate share of current partnership income irrespective of whether that income is actually distributed to them.\(^4\)

The prohibition against the anticipatory assignment of income, both from personal services and from assets was developed in the following cases: *Lucas v. Earl*,\(^5\) decided in 1930, held that an attorney could not enter into an agreement with his spouse whereby all acquisitions, including income from future services would be owned equally. *Eubank v. Helvering*,\(^6\) held that an insurance agent could not assign renewal commissions to his wife, and *Helvering v. Horst*\(^7\) determined that a father could not detach negotiable coupons and give them to his son while retaining ownership of the bond.

The Supreme Court in *Basye* determined the income was earned by the Partnership when Kaiser deposited the funds with the trustee in accordance with the agreement which had as its sole motive the circumvention of the tax statutes. As to the taxability of the income to the individual partner, the court reaffirmed the principle that a partnership is a conduit, not an entity, through which the income passes. This proposition of law is true even though the income is not distributed to the partners.\(^8\)

In conclusion we can only note that the ingenious plan developed by the taxpayers was dashed upon the rocks over very basic and elementary principles of taxation. The decision tends to lend support to the Proposed Regulation\(^9\) which treats voluntary salary reductions as income in the year the employer contributes the amounts to a qualified pension plan. This coupled with the pension reform being considered by both the House and Senate leaves little comfort or hope for the physicians even upon incorporation.

1.02 **Constructive Dividends.** In *Offshore Operations Trust*\(^10\) the court concluded that the measure of income to a shareholder of a Massachusetts trust, with transferable shares and taxable as a corporation for federal income tax purposes, is the fair rental value including consideration for the standby value in addition to actual use of the facility. Here the controlling shareholder used the yacht, Crows Nest IV, on most weekends during the summer. Since no charters or other

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\(^4\) 410 U.S. at 447.
\(^6\) *Eubank v. Helvering*, 311 U.S. 122 (1940).
\(^7\) *Helvering v. Horst*, 311 U.S. 112 (1940).
\(^8\) *Heiner v. Mellon*, 304 U.S. 271, 281 (1938). "The tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it may not be currently distributable, whether by agreement of the parties or by operation of law, is not material."
business use was made of the yacht, the court concluded the fair rental value should include the value of having the yacht available to the shareholder at all times.

In Nicholls, North, Buse Co. they found that "rental value should not be computed only for days of recorded use since we have held that the boat was freely available for personal use. . . ."\textsuperscript{11} The problem arose as to whether the taxpayer should be deemed to have received a constructive dividend equivalent to the cost of the yacht, Pea Picker III, of $68,687.72, or merely the fair rental value. The court held that the measure of a dividend is the fair rental value if the corporation is, and continues to be the actual owner of the facility. Fair rental value in Nicholls was determined by comparing the rental of similar yachts.

In the case at hand the constructive dividend was increased from $1,800 to $3,600 without any illustration or explanation as to how the value was calculated. Also it is interesting to note that the cost (including depreciation), of operating Crows Nest IV during the year in question exceeded $19,000. Finally, it is submitted that the shareholder in Offshore Operations received a very favorable disposition of his case in light of substantial cost of having the yacht available to him.

1.03 Use and Occupancy Insurance Proceeds. Shakertown Corporation v. Commissioner\textsuperscript{12} held that if insurance proceeds are paid for the loss of use and occupancy of a facility as contrasted to payment for lost profits, they are eligible for the nonrecognition provision of Section 1033. The Shakertown policy stated "Should the amounts insured hereunder exceed the assured's net profit plus fixed charges, then . . . the weekly amounts payable under the policy will be reduced."\textsuperscript{13} This clause was considered to be a limitation upon the insurer's liability and had no relation to the character of the recovery.

Nine years later in Maryland Shipbuilding and Drydock Co. v. United States,\textsuperscript{14} the Court of Claims determined that monies received under a policy section entitled "Docks—Loss of Earnings" resulted in ordinary income as the monies intended to replace lost profits during a shutdown of the drydock due to an accident.

The Treasury Department announced in Revenue Ruling 73-477\textsuperscript{15} that it would no longer follow the Shakertown decision. Therefore amounts received under a use and occupancy policy, which provides for

\textsuperscript{11} Nicholls, North, Buse Co., 56 T.C. 1225, 1241 (1971).
\textsuperscript{12} Shakertown Corp. v. Comm'r, 277 F.2d 625 (6th Cir. 1960).
\textsuperscript{13} Id. at 627.
\textsuperscript{14} Maryland Shipbuilding and Drydock Co. v. United States, 409 F.2d 1363 (Ct. Cl. 1969).
a per diem payment subject to a reduction if fixed charges plus lost profits are less than the specified payment, result in ordinary income and are not eligible for nonrecognition treatment under Section 1033.

1.04 Premature Withdrawal from Savings Account. Most financial institutions offer depositors both long-term and short-term savings accounts. If the depositor selects a long-term deposit for which the financial institution agrees to pay a stated rate of interest, he will be penalized for a premature withdrawal of his funds by losing the interest for 90 days. The financial institution is required to deduct the penalty from principal, if the interest has previously been withdrawn.

In Revenue Ruling 73-511 the Treasury ruled that the institution must report the gross amount of interest earned during the year, undiminished by the premature withdrawal penalty, on the annual information returns, Form 1099 INT and Form 1096. The taxpayer is required to report gross instead of net interest as income on his individual return. Regulation 1.6049-1(b) states:

[1]nterest is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment... and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.17

Neither the statutes nor the regulations make any provision for netting.

However the taxpayer is permitted a deduction for this loss under Section 165(c)(2) as "losses incurred in any transaction entered into for profit." The problem is that unless the savings account and forfeited interest relate to the taxpayer's trade or business, he is required to itemize his deductions to obtain a benefit from the loss.

1.05 Medical Student Loan Cancellation. If a medical student receives a loan from a state under a Medical Loan Scholarship Program and the loan, or a pro rata portion thereof, is subject to cancellation if the physician practices for five years in a rural section of the state, is the amount of the cancelled debt includable in income? The Treasury Revenue Ruling 73-256 answers in the affirmative citing Regulation 1.117-4(c) and Bingler v. Johnson.19

In Bingler v. Johnson the Supreme Court upheld the interpretation of the Regulations which disqualifies payments in the form of scholarships or fellowships which exact a quid pro quo from the recipients or were given primarily for the benefit of the grantor.

17 Treas. Reg. § 1.6049-1(b).
20 Treas. Reg. § 1.117-4(c).
The cancelled loans are includable as income and do not qualify for the scholarship or fellowship exclusion of Section 117, since the services do not relate to education and are required to further the grantor’s objective of providing medical service to rural areas of the state.

Although not discussed, this Revenue Ruling presents a serious precedent for treating the cancellation of National Defense Student Loans as income. This program permits up to 50% of the loan to be cancelled if the graduate serves as a full-time teacher at the elementary, secondary or college level or in a curriculum position such as dean, librarian, guidance counselor or enters the armed services of the United States.

1.06 Financial Counseling — Corporate Executive. A relatively recent executive fringe benefit, financial counseling, has been ruled to be an item of gross income by the Treasury. Revenue Ruling 73-13 not only treats the financial counseling fee paid by the corporation as income, but also subjects such compensation to withholding for F.I.C.A., F.U.T.A. and income tax.21

However, to the extent the fees are paid for tax or investment counseling, they are deductible from gross income under Section 212. This makes the itemizing of deductions on the executive’s personal tax return (1040) a condition precedent to obtaining the benefits of the deductions as set forth in the Treasury Regulations.22

1.07 Corporate Debt—Cancelled by Shareholder. Section 61(a)(12) requires the amount of cancelled indebtedness to be included in income. The Regulations make an exception when a corporate debt is forgiven by a shareholder.23

However, Revenue Ruling 73-432 points out a distinction between the cancellation of principal versus accrued interest.24 If the corporate debtor has previously deducted interest on its federal tax returns, income

22 Treas. Reg. § 1.212-1:
   (g) Fees for services of investment counsel...in connection with investments held by him [taxpayer] are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, ...of investments held by him...; (2) they are ordinary and necessary....
   (1) [E]xpenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his income tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible.
23 Treas. Reg. § 1.61-12:
   (a) The discharge of indebtedness, in whole or in part, may result in the realization of income....In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.
is realized by the corporation to the extent of accrued interest for which
it has obtained a tax benefit.

2.00 Exclusions from Income

2.01 Lodging and Meals. Section 61 of the Code defines gross
income to include “all income from whatsoever source derived...”
However, Section 119 allows an exclusion for meals and lodging furnished
to an employee for the convenience of the employer. For meals to qualify
for this exclusion, they must be furnished on the business premises of the
employer, and be furnished for the convenience of the employer.25 If
the value of lodging is to be excluded from the employee’s income, the
employee must be required to accept the lodging as a condition of his
employment in addition to the above-mentioned requirements, of being
furnished on the employer’s premises and for the employer’s convenience.26

The interpretation of Regulation Section 1.119 is not as difficult
when dealing with the “condition of employment” and “for convenience
of the employer” requirements. The problem arises when the courts
attempt to define “on the business premises.”

In Jack B. Lindeman27 the Tax Court examined the legislative intent
of the phrase “business premises” and found that it was intended to
have the same meaning as the phrase “place of employment” as used in
the House of Representatives28 version of the statute. The Regulations
contain illustrations of activities which occurred “on the business premi-
ises,” i.e., living quarters provided in a home for a domestic servant and
meals served cowhands while tending cattle on leased grass lands.29

In Commissioner v. Anderson the Sixth Circuit, reversing the Tax
Court, stated that living quarters two blocks from the business premises
were not “on” the premises: “Had Congress so intended,... it could readily
have used the words ‘in the vicinity of’ or ‘nearly’ or ‘close to’ or ‘contigu-
ous to’ or similar language, rather than say ‘on’ the business premises.”30

Mr. Lindeman was the manager of the Beach Club Hotel and for five
years lived in a four-room suite at the hotel. After a cost study, it was
decided it would be more profitable for the hotel to rent the suite and
provide other quarters for the manager. Since the hotel needed additional
parking, three lots across the street were acquired. Two of the lots were
used for overflow parking and the house on the third lot was used for the
manager’s residence. As manager, Mr. Lindeman, was on duty twenty-four

25 Treas. Reg. § 1.119-1(a) (1).
26 Treas. Reg. § 1.119-1(b).
27 Jack B. Lindeman, 60 T.C. No. 64 (July 25, 1973).
29 Treas. Reg. § 1.119-1(c) (2).
hours a day and frequently returned to the hotel in the evening when problems arose. He also used an office in the residence for planning social events for the hotel and for various telephone calls coming to him through the hotel switchboard.

The court determined that the house, as used here, was a part of the hotel's physical plant. Therefore "the lodging furnished petitioner is, within the meaning of Section 119, 'on the business premises of his employer.'"31

In the concurring opinion Judge Tannenwald felt the decision of the majority "comports within the legislative intention as to what constitutes 'on the business premises,'"32 but fails to define the outer boundaries of the statute.

In all probability we will see additional litigation involving the parameters which have been set forth by the courts in order to differentiate between across the street and two blocks away.

In Burl J. Ghastin33 the Tax Court addressed itself to the problem of excluding subsistence allowances of Michigan State highway patrolmen from gross income. This oft-litigated issue was decided in favor of the taxpayer by the Fifth, Eighth, and Tenth Circuits34 and in favor of the Commissioner in the First Circuit.35 Trooper Ghastin's subsistence allowance was originally based on three dollars a day for three meals, but was later recalculated and stated as an hourly rate. When the trooper worked in excess of eight hours per day he was paid overtime at a rate of one and one-half times his regular rate of pay plus one and one-half times the hourly rated subsistence allowance. He could carry a lunch or eat at his home, if his work assignment so permitted, although he was considered on duty during the meal break. Further, no accounting for meal expense to the employer was required.36

The court held that taxpayer was not furnished meals within the meaning of Section 119, since he was compensated. The Tax Court relied on the interpretation of meals, as decided by the First37 and Ninth Circuits,38 legislative history39 and the Treasury Regulations40 which re-

31 Jack B. Lindeman, 60 T.C. No. 64 (July 25, 1973).
32 Id.
33 Burl J. Ghastin, 60 T.C. No. 31 (May 22, 1973).
34 United States v. Keeton, 383 F.2d 429 (10th Cir. 1967); United States v. Morelan, 356 F.2d 199 (8th Cir. 1966); United States v. Barrett, 321 F.2d 911 (5th Cir. 1963).
35 Wilson v. United States, 412 F.2d 694 (1st Cir. 1969).
36 Burl J. Ghastin, 60 T.C. No. 31 (May 22, 1973).
37 Wilson v. United States, 412 F.2d 694 (1st Cir. 1969).
38 Tougher v. Comm'rs, 441 F.2d 1148 (9th Cir. 1971).
40 Treas. Reg. § 1.119-1(c) (2).
quire the employer to furnish meals "in kind" to qualify for the exclusion.

Continuing, the court held that the meals were not furnished for the convenience of the employer since no purpose of the employer was served. The court distinguished Morelan and Keeton where the troopers were required to eat in public restaurants.\footnote{United States v. Keeton, 383 F.2d 429 (10th Cir. 1967); United States v. Morelan, 356 F.2d 199 (8th Cir. 1966).}

Because of the conflict among the Circuits and the Tax Court, a definitive statement by the Supreme Court is necessary to clarify the problem.

2.02 Scholarships and Fellowships. Section 117 provides an exclusion from gross income of amounts received as a scholarship or fellowship grant. Subsequent regulations\footnote{Treas. Reg. § 1.117-3(c), 1.117-4.} have delineated a more precise definition of what constitutes a fellowship for the purposes of this section and what tests are to be applied by the courts in making determinations of whether money received is a fellowship.

Money received by medical interns and residents during their medical training at medical institutions and hospitals has been the subject of varied interpretations by the courts. Recent decisions in this area are illustrative of the difficulty in formulating a precise definition of a fellowship grant.

In Leathers v. United States,\footnote{Leathers v. United States, 471 F.2d 856 (8th Cir. 1972).} the Eighth Circuit allowed an exclusion under Section 117 to a resident physician for money he received from the University of Arkansas Medical Center. At issue was whether the money paid to physicians during their residency was a grant to enable them to receive advanced medical training or, was the money paid as compensation for services rendered to the hospital?

The Court of Appeals agreed with the lower court that the issue was a question of fact to be decided by the jury since there were incidents of both employment and training. The jury decided that the payments were made to allow the residents to pursue their studies and advance their training, and the Court allowed the verdict to stand. Reasons given by Court for the finding included: 1) there was no \textit{quid pro quo} extracted from the residents by the Medical Center for the money received; 2) the Medical Center was primarily a teaching institution for the purpose of medical education; 3) there was no prior employer-employee relationship between the Medical Center and the residents; 4) the work load of the Medical Center could have been handled without the assistance of the residents.

However, under circumstances similar to Leathers, the Fifth Circuit reached an opposite conclusion and denied an exclusion to a surgical...
resident. In Parr v. United States,\textsuperscript{44} the court granted a motion for summary judgment by the government, and held that the money received was for compensation and therefore taxable. The court relied on the reasoning of the United States Supreme Court decision of Bingler v. Johnson.\textsuperscript{45} There, the Supreme Court laid down a "no strings" test. The court stated that for money received to be considered a fellowship grant the grantor must be "relatively disinterested" in the work done by the recipient, otherwise the money would be considered compensation.

The Parr court followed the Fourth Circuit's decision in Hembree v. United States\textsuperscript{46} stating that the primary purpose of the institution is not a relevant factor in the determination of whether the amount received is a fellowship under Section 117. The court held: "Payments made for the 'primary purpose—to further the education and training of the recipient' are fellowship grants \textit{unless}—and the unless is a big unless—the amount provided for \textit{such} purposes represents compensation." In a perhaps somewhat prophetic aside, the court went on to note, "which is to say, this is not the last word, only the latest."\textsuperscript{47}

Decisions favorable to physicians under Section 117 have not been confined solely to jury trials. In a recent Tax Court decision, Frederick A. Bieberdorf,\textsuperscript{48} a physician was allowed an exclusion for a grant from funds of the National Institute of Health. Although the doctor spent 20\%-25\% of his time in a clinic with patients, the court held such services were only a small part of a program designed for individual study and research. The opinion also noted that the research done by the doctor was not for the benefit of the grantor alone, but was for the academic community in general.

Whether or not an exclusion is permitted under Section 117 as a fellowship grant depends for the most part on whether or not there are "strings" attached to the money received. Revenue Ruling 73-255\textsuperscript{49} emphasizes this interpretation of the section and indicates the exclusion will be denied if there is an element of \textit{quid pro quo}, money for services, attached to the fellowship.

\textbf{2.03 Sick Pay.} Under Section 105(d), the Code provides for an exclusion from gross income of amounts received as "wages or payments in lieu of wages for a period when an employee is absent from work on account of personal injuries or sickness. . . ." The Treasury Department

\textsuperscript{44} Parr v. United States, 469 F.2d 1156 (5th Cir. 1973).
\textsuperscript{46} Hembree v. United States, 464 F.2d 1262 (4th Cir. 1962).
\textsuperscript{47} 469 F.2d at 1159.
\textsuperscript{48} Frederick A. Bieberdorf, 60 T.C. No. 14 (April 24, 1973).
\textsuperscript{49} Rev. Rul. 73-255, 1973 INT. REV. BULL. No. 24, at 6.
has asserted by regulation that such an exclusion is not allowed after the earliest time which the employee could have retired. 50

In *Brooks v. United States*, 51 the taxpayer asserted that he had a right to an exclusion under Section 105(d) until the mandatory retirement age and not at the earliest age at which retirement was possible. Because of a heart condition and illness, Brooks was pensioned at age 60 after 37 years of service. Even though he was eligible for longevity retirement, it was stipulated that Brooks would have worked to age 65 but for his illness. Brooks claimed an exclusion of $100 per week for amounts received in lieu of wages because of illness between ages 60 and 65.

The issue presented was whether the regulation of the Treasury Department is in conflict with the Code so as "to withdraw a benefit conferred upon him [the taxpayer] by the Code Section 105(d), and as such it is an impermissible assumption of authority by the commissioner." 52

The Fifth Circuit, citing an earlier district court decision of *Walsh v. United States*, 53 held that the automatic termination of the exclusion "when an employee becomes eligible for service retirement . . . is invalid as adding an unauthorized restriction on a statutory benefit." 54 The court felt that the money received between age 60 and 65, under the language of the statute, was received because of the taxpayer's absence from work due to illness.

*Brooks* was cited by the court in the case of *Reardon v. United States*, 55 to allow an exclusion under Section 105(d) to an attorney who retired from the Internal Revenue Service at age 51 due to illness and claimed the sick pay exclusion applied till he reached age 70, the mandatory retirement age. The Commissioner had asserted the exclusion ended at age 60, when Reardon first became eligible to retire. A similar result was reached for a taxpayer who had worked for the Central Intelligence Agency in a decision by the Court of Claims. 56

### 2.04 Foreign Income.

Under the provisions of Section 911 a nonresident taxpayer may be allowed to exempt from his gross income amounts received from sources outside the United States that are attributable to payment for services performed outside the United States.

A recent decision of the Tax Court construing this section of the Code is significant not only for the construction it gives of this section, but

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52 Id. at 831.
also for the broad definition of services that was delineated. In *Mark Tobey*, the court had to decide whether a taxpayer living in Switzerland and working in his own studio as an artist was within the provisions of Section 911 for amounts received from the sales of his paintings. The Treasury Department contended the money received could not be deemed a "service" since there was no independent recipient of the taxpayer's work; the only thing the recipients (purchasers of the paintings) obtained were products of work—not services.

The court concurred with the Treasury stating: "The key element is the presence or absence of capital as the income producing factor, not the existence or non-existence of an independent recipient for the personal service rendered by the taxpayer." The court also noted: "If the taxpayer's personal efforts result in the creation of personal property, the gain derived from the sale of that property is properly categorized as 'earned income.' " Whether this definition is applicable outside of Section 911 remains to be seen, but the inclusive nature of the definition should not be overlooked.

### 3.00 Exemptions

#### 3.01 Dependents. Personal and dependent exemptions are allowed as deductions in computing taxable income, and provisions for such exemptions are in Sections 151 and 152. Section 151(e) provides an exemption for dependents, and Section 152(e) is concerned with which parent is to be allowed an exemption for his or her child when the parents are divorced or legally separated. If no provision is made in the divorce decree or written separation agreement, the parent not having custody of the child may claim an exemption only if:

(i) the parent not having custody provides $1,200 or more for the support of such child (or if there is more than one such child, $1,200 or more for all such children) for the calendar year, and

(ii) the parent having custody of such child does not clearly establish that he provided more for the support of such child during the calendar year than the parent not having custody.

The question has arisen, that under the provision of paragraph (ii) where the custodial parent seeks to clearly establish that he or she has "provided more for the support of such child," may said parent include the amount provided by his or her new spouse. In other words, may the amount provided by the mother and stepfather be combined to establish that the custodial parent (the mother) provided more for support than the non-custodial father.

The Treasury Department recently addressed itself to this issue in

57 Mark Tobey, 60 T.C. No. 27 (May 17, 1973).
58 Id.
59 INT. REV. CODE OF 1954, § 152(e)(2)(B) (i) & (ii).
Revenue Ruling 73-175. The ruling provides that the amount of support provided by the custodial parent may be combined with the amount of support provided by said parent's new spouse to meet the criteria of paragraph (ii). The Treasury reasons that such a rule allows for a much simpler means of establishing who shall be entitled to a deduction. This ruling reverses the position of the Treasury on this issue and in effect revokes Revenue Ruling 71-19.

3.02 Blindness. Previously, a taxpayer, claiming an exemption for himself or his spouse not totally blind, was required to annually attach a physician's certification stating that the central visual acuity did not exceed 20/200 in the better eye with correcting lenses or that the widest diameter of the visual fields subtends an angle of 20 degrees or less.

Under a recent Treasury decision, if the physician certifies that there is no reasonable probability of improvement in the visual acuity, i.e., the condition is certified as "irreversible," and the examination occurred during the taxable year for which the exemption is claimed, the additional certifications need not be attached to the taxpayer's return in subsequent years, provided this condition remains "irreversible.

4.00 Bad Debt

4.01 Carrying on a Business—Definition. Different treatment is accorded bad debts which become wholly or partially worthless during a taxable year. If the bad debt is considered as resulting from taxpayer's business, Section 166 permits a dollar for dollar deduction. This deduction may be calculated by deducting the total debt from gross income if the debt becomes wholly worthless during the taxable year or by a reasonable addition to a reserve established for bad debts. If the business debt is recoverable in part, an amount may be deducted which does not exceed the amount charged off during the taxable year. However, if the bad debt is found not to result from the taxpayer's business, it must become wholly worthless before it will be treated as a short-term capital loss. What constitutes carrying on a business, however,
has met with some definitional difficulty and the Treasury Regulations have avoided making a comprehensive pronouncement.\(^{66}\)

In *Richard H. Tunstead*,\(^{67}\) the taxpayer and his wife claimed a business bad debt deduction resulting from a 1967 foreclosure loss. Both engaged in the practice of purchasing several second mortgages as investments from 1961-1967. The court found proof that they were not engaged in the real estate business since “the time and effort . . . devoted to their real estate business was not sufficiently engrossing to meet the standard.”\(^{68}\) The standard was established as an undertaking to which one habitually devotes time, attention or effort with substantial regularity. In addition, the court pursued objective standards to support this position, finding a failure to pay a state self-employment income tax on the interest income received. The logic of this decision is questionable in that a determination of federal income tax treatment appears to have hinged on payment of a state tax, whereas, better support might be found in a failure to pay social security taxes under the self-employment provisions of the Social Security Act.

**4.02 Stockholder’s Loan to Corporation.** When a corporation fails to repay a loan from a stockholder-employee, has a business or non-business bad debt occurred?

In *United States v. Generes*\(^{69}\) the “dominant motivation” standard was substituted for the “significant motivation” test\(^{70}\) in determining the business/non-business aspect of the debt. The employee-stockholder was considered as making loans to his business with two motives: to protect his investment and to protect his employment.\(^{71}\) Thus, by making the “dominant motivation” of the taxpayer the measure, the mere presence of a business motive will not fully control the tax result. Although, loans made for the protection of one’s job or salary may suffice for business bad debt treatment.\(^{72}\)

In *Odee Smith*\(^{73}\) the “dominant motivation test” was applied to loans

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\(^{66}\) 2 P-H 1973 FED. TAXES ¶ 11,010. See Flint v. Stone Tracy Co., 220 U.S. 107, 171 (1911) where pursuits occupying man’s time, attention, and labor for livelihood or profit purpose were identified as a business. But see, Oliver B. Kilroy, 42 P-H TAX CT. MEM. 29 (1973), where no basis was found to support taxpayer’s contention that he was in the mining exploration business and the considerable nonbusiness income of taxpayer was indicative of his lack of profit motive.


\(^{68}\) *Id.* at 511. See Fahs v. Crawford, 161 F.2d 315, 317 (5th Cir. 1947).


\(^{70}\) Weddle v. Comm’r, 325 F.2d 849, 851 (2d Cir. 1963). But see, Niblock v. Comm’r, 417 F.2d 1185 (7th Cir. 1969).

\(^{71}\) 405 U.S. at 99.


\(^{73}\) Odee Smith, 60 T.C. No. 38 (May 31, 1973), on remand, 457 F.2d 797 (5th Cir. 1972).
already made to protect the taxpayer's credit rating, and thus, his floundering business. The court, reversing its prior application of the significant motivation standard, found that the "dominant motive" for the loan was to protect his investment and accordingly gave non-business bad debt treatment to the loss. However, one loan made to the business after it had ceased operations was found necessary to protect the taxpayer's creditors and credit rating, resulting in business bad debt treatment. This case is instructive as to future application of the dominant motive test.

4.03 Accrued But Unpaid Child Support. Are bad debt deductions allowable for accrued and unpaid child support payments which a divorced parent, pursuant to a court decree, has been ordered to make but has failed to perform? In Imeson v. Commissioner,74 the uncollected support payments were not considered a bad debt within the meaning of Section 166. Since the "debt" is not derived from the capital or income of the taxpayer it is not a true debt.75 The obligation will be treated as comparable to earned but uncollectable, unpaid wages, which, though worthless, are non-deductible unless the income these items represent has already been included in that year's income tax return or that of some previous year.76

Two burdens of proof confront a taxpayer seeking to deduct these accrued but unpaid expenses. First, evidence must be introduced showing the amounts actually expended for support do not exceed the ex-spouse's obligation and secondly, evidence must show that the debt owing became totally worthless during the year(s) for which the deduction(s) was taken.

If the burdens are not carried, the deduction is denied presumably because there is no out-of-pocket realized loss.77 This rationale is applicable not only to child support payments which are owed but unpaid, but also to unpaid alimony obligation and various expenses incurred in attempted collections.78

In Imeson, the court agreed that the deductibility of these "debts" was an arguable point but refused to resolve these conflicting questions.

4.04 Intra-family Debt. Is a non-business bad debt deduction, under Section 166, permitted for a debt, which is created pursuant to a separation agreement and subsequent divorce, if the debt becomes worthless in the hands of an assignee following an assignment?

75 Dale A. Swenson, 43 T.C. 897 (1965).
76 5 MERTENS, LAW OF FEDERAL INCOME TAXATION ¶ 30.12 (1969). See Dale A. Swenson, 43 T.C. 897 (1965); John L. Seymore, 14 T.C. 1111 (1950). In the principal case, the taxpayer failed to carry both of these burdens.
77 Long v. Comm'r, 96 F.2d 270 (9th Cir. 1938), cert. denied, 305 U.S. 616 (1938).
78 W. Thomas Menefee, 8 T.C. 309 (1947).
In Green F. Johnson\textsuperscript{79} the Tax Court concluded that no deduction would be permitted. The spouses executed a written separation agreement containing an acknowledgment of a $4,270 indebtedness between husband and wife including a 6% per annum interest charge that was to continue until the principal was paid. The wife assigned this indebtedness to her father who obtained a default judgment against the husband for $5002.60. The full amount was deducted by the father as a non-business bad debt. The IRS argued that there was no debtor-creditor relationship between husband and father, and notwithstanding this premise, it further argued that the obligation was worthless at its creation and assignment.

In order to justify a bad debt deduction it is incumbent to show a valid debtor-creditor relationship.\textsuperscript{80} When an intra-family loan is made, it is often considered a gift and a debtor/creditor relationship is not found.\textsuperscript{81}

The Court concluded that even though the debt was incorporated in the separation agreement and was legally enforceable, that alone does not automatically make it eligible for a bad debt deduction. Since this "debt" could be considered worthless from its inception it could not be deducted under Section 166.\textsuperscript{82}

\textbf{4.05 Bad Debt and Life Insurance Proceeds.} If insurance is purchased on a debtor's life, but the proceeds received following his death are not restricted to the amount of outstanding indebtedness, may the creditor take a bad debt deduction for the then wholly worthless outstanding debt and further exclude the insurance proceeds from gross income for that year? It appears that Thomsen & Sons v. United States\textsuperscript{83} opens the door to such a possibility. A manufacturer purchased "key man" insurance on its exclusive California distributor. The distributor was killed while still owing $48,053.97 to the manufacturer, who received $50,444.92 in death benefits. At trial the IRS contended that the proceeds were not paid by reason of the insured's death and were not properly excludable. Since the proceeds of insurance nearly equated the outstanding indebtedness, arguably the motive for the purchase was to guarantee collectibility of the account receivable. The jury was instructed to apply "good common sense" to determine whether the proceeds were paid by reason of the insured's death. The jury found the proceeds taxable and the debt totally worthless. On appeal, the manufacturer's motive for originally purchasing the insurance was found immaterial to the application of Section 101(a) (1), which in part provides that gross income does not include amounts which are received under a life

\textsuperscript{79} Green F. Johnson, 42 P-H TAX CT. MEM. 756 (1973).
\textsuperscript{80} Treas. Reg. § 1.166; see Elizabeth N. Rude, 48 T.C. 165, 172 (1967).
\textsuperscript{81} Evans Clark, 18 T.C. 780 (1952), aff'd, 205 F.2d 353 (2d Cir. 1953).
\textsuperscript{83} Thomsen & Sons, Inc. v. United States, 484 F.2d 954 (7th Cir. 1973).
insurance contract paid by reason of the insured's death. The court further found it natural that the proceeds of insurance were not limited to the outstanding indebtedness at death.

It appears that a double benefit is possible, a bad debt deduction for unsatisfied indebtedness and also an exclusion from gross income of the insurance proceeds. This is especially true where a "key man policy" is purchased and a convincing argument is presented that the insurance is to indemnify against injury to a going business, not as an assurance of collectibility of a receivable. It is significant to note that the IRS did not appeal the jury finding of the non-collectibility of the debt. This may throw some doubt on the availability of double benefits in future litigation if a similar situation occurs.

5.00 Deductions

5.01 Home Office Expense. Section 162(a) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

It is this section which a taxpayer must comply with if a business expense deduction is to be achieved. One such deduction, which has been subject to extensive litigation in recent years, involves the right of an individual executive or employee to deduct those expenses incurred in maintaining an office in his home.

The Treasury has accepted for some time the right of a taxpayer to use part of his home as a professional or business office and deduct the portion of his rent and other similar expenses attributable thereto as a business expense.\textsuperscript{84} However, the Service has attempted to impose far stricter requirements on executives and employees before allowing them a deduction for home office expenses.\textsuperscript{85}

Revenue Ruling 62-180 placed the burden of proof upon the taxpayer to establish, among other factors, that he was \textit{required} to provide his own facilities as a \textit{condition} of his employment and that he regularly used a part of his personal residence for that purpose.\textsuperscript{86}

The Tax Court has often rejected the Treasury's position that the employee must be required, as a condition of his employment, to provide his own space in his home. It has been held, if the home office is "appropriate and helpful" the taxpayer qualifies for a deduction.\textsuperscript{87}

\textsuperscript{84} Treas. Reg. § 1.262-1(b)(3).
\textsuperscript{86} Id. at 53.
The *Newi* case, one of the first to clearly establish the "appropriate and helpful" test regardless of Revenue Ruling 62-180, was appealed to the Second Circuit Court of Appeals. Mr. Newi sold advertising time for a television network and worked at night in a den in his apartment. He was not required or requested to set aside the space and in fact had office space available for his use in the evenings. The Tax Court allowed a deduction for a portion of the rent, electricity, and cleaning of his apartment as an ordinary and necessary business expense. The basis of the Tax Court decision was the Supreme Court's interpretation of the "ordinary and necessary" standard in Section 162 as imposing only the requirement that the expenditure be "appropriate and helpful" to the taxpayer's business.

The Commissioner argued on appeal that the taxpayer's use of the study was purely personal and therefore was not deductible. He further alleged the Tax Court's construction of the phrase "ordinary and necessary," "would open the doors for a business deduction to any employee who voluntarily chose to engage in an activity at home which conceivably could be helpful to his employer's business."

The Court of Appeals for the Second Circuit did not believe the Commissioner's concern was justified and held the Tax Court's decision was reasonable under the facts of this case.

However, the taxpayer in *Paul J. O'Connell*, relying upon *Newi*, was denied a deduction for his home office. The Tax Court distinguished *Newi* on the ground that it was more practical for Mr. Newi to do his work at home while Mr. O'Connell was unable to prove he "could not have done his work at the office as well or better than at his apartment."

It is submitted that the *Newi* and *O'Connell* decisions are not distinguishable on their facts as the Tax Court believed. Furthermore, the Tax Court in *O'Connell* cited with approval Revenue Ruling 62-180 and noted the taxpayer was not required as a condition of his employment to maintain an office in his home.

In 1973, there was a continued liberalization by the courts of the Treasury's position as to the allowance of a deduction for a home

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88 Newi v. Comm'r, 432 F.2d 998 (2d Cir. 1970), aff'd, 38 P-H TAX CT. MEM. 735 (1969). Although it can be argued *Herman E. Bischoff*, 35 P-H TAX CT. MEM. 603 (1966) was the first case to establish this test, the facts indicate an implied requirement to have a home office.


90 See INT. REV. CODE OF 1954, § 262.

91 432 F.2d at 1000.


93 *Id.* It should be noted that the "appropriate and helpful" test was still followed by the Tax Court in other cases. See e.g., Richard Keith Johnson, 41 P-H TAX CT. MEM. 983 (1972).
office. There is also an indication the Internal Revenue Service is retreating from its position as set forth in Revenue Ruling 62-180.

In LeRoy W. Gillis, the taxpayer was a district sales manager of an insurance company. Although he was not required to, Mr. Gillis maintained a room in his home as an office. The Commissioner did not rely on the "employer requirement," as found in Revenue Ruling 62-180, in arguing for the disallowance of the deduction. Instead, the government contended the taxpayer's duties did not necessitate the maintenance of an office in his home because his employer furnished him with adequate facilities located near his home. Thus, it was asserted that the taxpayer's home office was a mere duplication of his employer's facilities and as such was not deductible by reason of Section 262.

The court held, the mere existence of duplicate facilities does not of itself demand the disallowance of a deduction for home office expenses. The court was of the opinion that a deduction for a home office should be held to the same test as any other business expense. Therefore, if it is appropriate and helpful, rather than for the mere convenience of the taxpayer, a deduction should be allowed. The maintenance of the home office by the taxpayer was found to be appropriate and helpful in carrying on his duties and was more than for his mere convenience. It is noteworthy that one of the factors considered by the Tax Court in reaching its result was the hazards of working alone downtown at night.

In Thomas J. Green, Jr., although the litigated issue dealt with the taxpayer's commuting expenses, a surprising stipulation was entered into regarding the taxpayer's home office. Mr. Green spent time in the evening in his den reviewing his business activities of the day and preparing for his next day's business activities. The taxpayer's reasons for working at home were purely personal in nature; however, the parties agreed the taxpayer was entitled to deduct the fair rental value of his den as a business expense. As a stipulation is only binding in the case at issue, it is the author's opinion that this case does not represent a total reevaluation of the Treasury position.

A recent case reported, with respect to a deduction for a home office, involved an IRS attorney who took work home from the office on weekends and evenings and used a room in his apartment for this purpose. The taxpayer contended the claimed deduction was an ordinary and necessary business expense under Section 162(a). The Commissioner

95 Id.
96 Thomas J. Green, Jr., 59 T.C. No. 44 (Dec. 20, 1972).
97 42 P-H TAX CT. MEM. 423 (1973).
98 Stephen A. Bodzin, 60 T.C. No. 86 (Sept. 4, 1973). The taxpayer usually worked in his office two or three evenings during the week and for three to five hours on weekends.
contended the taxpayer must show he was required to work after hours and that his employer failed to provide him with an adequate office to perform this work. The IRS attempted to rehabilitate Revenue Ruling 62-180 by construing the phrase “required as a condition of employment” to mean “required in order to perform his duties.” This approach was found to be unsatisfactory as being too strict. The court allowed the deduction for the home office finding its use appropriate and helpful to the performance of the taxpayer’s duties. Although the use of the home office served his own convenience, this was not the primary reason for its maintenance as it was also more efficient.

The dissenting opinion of Justice Scott recognized the precedents for the decision but viewed the deduction as purely personal. He believed:

[N]o professional person and very few if any business people, who would not be entitled to deduct as a business expense some portion of the cost of rental of a home or the maintenance of a house since the great majority of such persons do professional reading and written work for themselves or their employers in their homes.99

Justices Featherston and Quealy, also dissenting, analogized the home office deduction to the transportation of job-related materials to work.100 Justice Quealy would require the taxpayer to prove the space claimed for the home office “would not have been acquired except for such purpose.”

One may conclude from the above decisions that the Treasury’s position as to a home office deduction, as expressed in Revenue Ruling 62-180, will find little support among the courts. It appears the most generally accepted test is whether the home office is “appropriate and helpful” to the taxpayer. It is predicted that the Treasury will change the thrust of its argument away from Revenue Ruling 62-180 toward the Fausner approach as discussed by the dissent in Bodzin.

Once it has been determined that a deduction for a home office is permissible, the question arises as to the proper method of calculating the deduction. The Commissioner has once again relied on Revenue Ruling 62-180 to determine the answer, wherein it is provided:

Where a portion of the residence is regularly used for business purposes only part of the time, a further allocation must be made on the basis of the ratio of the time the area is actually used for business purposes to the total time it is available for all uses. (Emphasis added.)101

The result of employing this formula is that any calculation will be

99 Id.
100 See Fausner v. Comm’r, 413 U.S. 838 (1973), aff’g, 472 F.2d 561 (5th Cir. 1973).
based on a twenty-four-hour day since this will always be the amount of time the room is available for use.

In *George W. Gino,* the Commissioner asserted the proper formula to apply in computing the deduction was found in Revenue Ruling 72-180. However, the court held the correct method to apply "is the ratio of hours of business use to hours of total use of the rooms in issue." The court's rationale was that a dual-use facility is just as much available for business as it is for non-business use when not occupied. In other words, the proportion is the amount of hours the room is used as a business office over the total number of hours it is actually used during the course of a day.

The *Gino* case points out the great advantage the taxpayer receives by using the court's approach. While the Commissioner argued the deduction should be $\frac{2}{24}$ths (the number of hours of business use over the number of hours in a day), the taxpayer argued, and the court accepted, that the deduction should be $\frac{2}{8}$ths (the number of hours of use for business purposes over the number of hours the room was used for other activities).

In *LeRoy W. Gillis,* after concluding the taxpayer's home office was appropriate and helpful in carrying on his duties, the court concluded the office was used 80 percent for business and 20 percent for personal purposes. The office took up one-eighth of the area of the home. Consequently, the court allowed a deduction for depreciation based on 80 percent of one-eighth of the capital expenditure, and a deduction of 80 percent of one-eighth of the residential expenditures.

The foregoing 1973 cases indicate the courts are also liberalizing the Treasury position as to how the deduction will be computed. Of course, if the home office is used exclusively for business there will be no problem in deducting all of the allowable costs. However, a further allocation based on use will be necessary if the office serves other purposes.

It is suggested that if the office is to be used for other than business related purposes, such use be kept to a minimum. In addition, one should be able to adequately substantiate business versus non-business uses with documented evidence (i.e., timecharts). In conclusion, the expenses related to maintaining an office in the home will generally include a proportionate share of depreciation for the home owner or rental for the renter; utilities; maintenance, and insurance.

**5.02 Commuting—Carrying Tools of Trade.** One may not deduct the cost of commuting between his residence and place of business as a

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103 *42 P-H TAX CT. MEM. 423* (1973).
business expense. However, one may deduct transportation expenses incurred in getting from one place of business to another. The question arises whether one may deduct traveling expenses between one's home office and office in the city. Thomas J. Green, Jr. deals with this issue.

In Green, the taxpayer used the den in his home as an office. The taxpayer contended his round-trip expenses between his Long Island residence and Manhattan place of business was a deductible business expense. The taxpayer contended his den and his office in Manhattan constituted two places of work and therefore traveling between them was not commuting. The Commissioner alleged the travel expenses were commuting expenses and as such not deductible. The court found for the Commissioner on the ground that the taxpayer's personal residence was not a principal office. It is submitted that if one's home can be classified as a principal place of employment, he will meet with success in the Tax Court in deducting his expenses between his home and an office in the city.

Russell Anderson dealt with the issue whether one could get a business expense deduction for auto expenses incurred driving from the union hall, where daily work assignments were picked up, and the places of employment assigned. The court held the costs were non-deductible commuting expenses because it was the union which imposed the requirement of daily stops and not the employer. Therefore, the taxpayer's traveling did not constitute business trips.

Although admittedly commuting expenses are not deductible, the question arises whether or not a deduction is allowed if one is transporting the tools of his trade from his home to his place of employment?

The Commissioner's original position was to disallow any deduction for commuting expenses notwithstanding the fact the taxpayer was also transporting tools. The rationale was that the expenses of the taxpayer were not incurred by the carrying of the tools; therefore, the entire amount of the expenses were deemed to be commuting, with no part allocable to the transporting of tools. However, the Treasury

104 Treas. Reg. § 1.162-2(e).
105 Candler v. Comm'r, 226 F.2d 467 (2d Cir. 1955).
106 Thomas J. Green, Jr., 59 T.C. No. 44 (Dec. 20, 1972).
108 Mr. Green based his argument on language found in "Your Federal Income Tax." The court discounted this publication as not being authoritative law. See Dixon v. United States, 381 U.S. 68, 73 (1965).
110 Rev. Rul. 25, 1956-1 CUM. BULL. 152.
position was modified in Revenue Ruling 63-100. Where one would not use his automobile except for purposes of transporting the tools of his trade, the transportation expenses are deductible.

The Court of Appeals for the Second and Seventh Circuits have allowed deductions for some allocable portion of traveling expenses even though the taxpayer would have driven to work in any event. The Second Circuit recently reaffirmed its decision in Sullivan, in Coker v. Commissioner, stating that any change in its rule should come from the Congress or the Supreme Court.

Mr. Coker claimed he was entitled to deduct his entire traveling expense, even though he would have driven to work anyway, because his duties as a carpenter shop steward necessitated the carrying of 200 pounds of tools. The Commissioner argued the taxpayer was not entitled to any deduction. The court affirmed the Tax Court's allowance of a deduction of a reasonable percentage of the commuting expense allocable to the transportation of his tools.

Yet, in Fausner v. Commissioner, the Fifth Circuit Court of Appeals declined to follow the view of the Second and Seventh Circuits and affirmed a Tax Court decision disallowing a deduction in toto for the automobile expenses incurred by a pilot transporting his flight bag and overnight bag from his home to his place of employment. The court felt there was no rational basis upon which an allocation could be made between the nondeductible commuting expenses and the deductible business expense. The Supreme Court granted certiorari to settle the dispute between the circuits.

Mr. Fausner argued he was entitled to deduct the entire cost of his automobile expenses on the theory they were incurred in transporting his bags. The taxpayer did not dispute the fact he would have commuted by automobile regardless of whether he had to transport his bags.

The Supreme Court in a per curium opinion affirmed the Fifth Circuit's holding on the theory that the mere fact the taxpayer must carry

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111 Rev. Rul. 100, 1963-1 CUM. BULL. 34, wherein a musician who used his car to transport bulky musical instruments, and who would not have otherwise used his car, was permitted to deduct his transportation expenses.
112 Sullivan v. Comm'r, 368 F.2d 1007 (2d Cir. 1966); Tyne v. Comm'r, 385 F.2d 40 (7th Cir. 1967). The Second Circuit noted in Sullivan that if a means of storage was feasible, the cost of this alternative should represent the maximum allowable deduction for transportation of the tools.
113 Coker v. Comm'r, 480 F.2d 146 (2d Cir. 1973).
114 472 F.2d 561 (5th Cir. 1973).
115 Donald W. Fausner, 40 P-H TAX CT. MEM. 1248 (1971). This same taxpayer was allowed a deduction by the Tax Court for an allocable portion of his commuting expenses attributable to his bags when he lived in New York. 55 T.C. 620 (1971). (This case would have been appealable to the Second Circuit.)
"incidental of his occupation" does not remove the expense from the exclusion of Section 262. However, the court noted: "Additional expenses may at times be incurred for transporting job-required tools and material to and from work." The Court further stated, "in such a situation, an allocation may be feasible." 117

It would seem the Supreme Court decision in Fausner may have gone even further than the Treasury in disallowing a deduction for the transportation of tools of one's trade. An analysis of the court's holding, and in particular its reliance on Revenue Ruling 63-100 and comment thereafter, indicates that not only does the court favor a deduction in only those cases where the automobile would not have been used but for the tools, but furthermore, in such a situation an allocation would be required. The Commissioner's position, as set forth in Revenue Ruling 63-100, is to allow a deduction for the entire traveling expenses incurred if the taxpayer would not otherwise have used his automobile.

It is also possible to interpret the court's language as setting forth two alternatives to gain a deduction for expenses incurred in transporting tools. First, an entire deduction is allowable if the taxpayer can show he would not have used his car but for the transportation of his tools. Second, if additional expenses are incurred in transporting tools the taxpayer would be entitled to deduct the additional expenses. Although this alternative interpretation, quite honestly, seems to conflict with the express language and citation of the court it is hoped the Fausner decision is construed in this manner.

A reexamination of the Coker decision, in light of Fausner, clearly illustrates the import of the latter case in the area of transportation of tools.

On October 17, 1973, the Second Circuit granted the government's petition for rehearing Coker. Taxpayer's deduction was not permitted since he would have used his automobile even if he was not transporting his 200-pound tool box and he presented no evidence that additional expenses were incurred.

Thomas L. Bradley, 118 the first Tax Court case decided after the Supreme Court decision in Fausner, denied a National Park Service police officer a deduction for auto expense since the court could not determine, from the record, that the taxpayer would have used public transportation except for the fact he needed to carry police equipment with him. Mr. Bradley:

[...]ore his uniform to and from work assignments, and carried with him in his automobile the following equipment: (1) a so-called "riot bag" or duffel bag, two or three feet long and 15 to 18 inches

117 Id. at 839. The court cited Rev. Rul. 63-100, presumably as an example of a deductible expense.

in diameter, containing boots, raincoat, helmets, gas mask, night stick, and other items; (2) a briefcase approximately 17 or 18 inches long, 12 inches wide, and 4 inches deep, containing traffic code books for Maryland and the District of Columbia, ticket books, steel measuring tape, a box of 38-caliber shells, and various other items; (3) another briefcase of equal size, containing an emergency blanket, a map, a general order book, and bandages; (4) a large metal flashlight; and (5) a "rool-a-tape" measuring device 18 inches long having a metal handle. The foregoing equipment weighed 51 pounds in the aggregate; all of it was necessary for the conduct of petitioner's duties, and petitioner was required to keep it with him at all times.\(^{119}\)

The Tax Court appears to have adopted the "except for" test of \(Fausner.\) It is interesting that the court did not mention the aspect of additional expenses; although it can be reasoned that with only a 51-pound load, the issue was irrelevant in the case at hand.

The final development which will be discussed in the area of transportation expenses is Revenue Ruling 73-191.\(^{120}\) The taxpayer who requested advice was an employee who drove his automobile on business and was reimbursed by his employer at the rate of eight cents per mile. On his income tax return, the taxpayer elected to take a business expense deduction under Section 162(a) for the difference between the standard mileage rate of twelve cents per mile\(^{121}\) and his eight-cent-per-mile reimbursement. There was no detailed information concerning meal and lodging expenses included in his return.

The Commissioner determined the taxpayer did not comply with the appropriate reporting requirements;\(^{122}\) therefore, the deduction was not allowable. The Commissioner stated the transportation expenses could be computed by using the standard mileage ratio. However, compliance with adequate accounting to the employer provisions of the regulations\(^{123}\) could not be relied upon by the taxpayer to substantiate his deduction.

The effect of Revenue Ruling 73-191 is to place the burden on the taxpayer who is not fully reimbursed by his employer to maintain records and supportive evidence of all his expenses incurred if he

\(^{119}\) Id. at 772.

\(^{120}\) Rev. Rul. 73-191, 1973 INT. REV. BULL. No. 17, at 10.


\(^{122}\) Treas. Regs. §§ 1.274(e)(2)(iii), 1.274-5(e)(3) and 1.162-17(b)(3) provide that when an employee incurs deductible business expenses in excess of his reimbursements from his employer he must submit a statement as part of his return indicating the total of all amounts received as reimbursements. He must prepare a detailed analysis of his expenses broken down into transportation expenses, meals and lodging, entertainment and other business expenses. In addition, he must maintain records and supporting evidence to substantiate his claim.

\(^{123}\) Treas. Regs. §§ 1.274-5(e); 1.162-17(b).
wishes to obtain a deduction for those expenses not reimbursed, even though he has already accounted to his employer.

5.03 Commuting—Distant Jobsite. In Boone v. United States, the court once again faced the problem of the deductibility of expenses incurred in daily travel to and from a distant jobsite when the job is known not to be of a permanent nature. In this case, the taxpayer claimed that the daily commuting expenses were an allowable deduction under Sections 161 and 162 since the job was of a temporary nature. The district court agreed with the taxpayer and allowed the deduction under Section 162(a)(2). The Fifth Circuit reversed, holding the job was not of a temporary nature but was of an indefinite duration and therefore no deduction was permissible. The court of appeals cited the following factors as relevant in its determination that the job was indefinite and not temporary: 1) the job could be terminated at any time; 2) the taxpayer had no way of knowing how long the job would last when he was hired; 3) the taxpayer was actually employed 15 months.

5.04 Legal Fees—Divorce, Estate Planning, Liquidation. Section 212 provides that an individual may obtain a deduction for all the ordinary and necessary expenses incurred “in connection with the determination, collection, or refund of any tax.”

Generally, attorney’s fees and other costs paid in connection with a divorce, separation or support decree are not deductible, although those expenses incurred for tax counsel or determining tax liability are deductible. However, there must be an allocation if the expense is incurred in an activity not solely relating to tax matters. The Treasury concedes a deduction is possible, under Section 212(3), for the portion of counsel fee in a divorce proceeding allocable to tax counsel.

Sidney Merians dealt in part with the deductibility of estate planning fees. Dr. Merians retained a law firm to prepare an estate plan for he and his wife. An attorney prepared a will taking into consideration requirements for qualification for the marital deduction; established an irrevocable trust; transferred stock to that trust; dissolved a corporation, and created a partnership with the trust as a limited partner to hold the real estate which the corporation owned. Gift tax returns were also prepared in connection with the creation of a life insurance trust. The taxpayer received a bill for legal services which the petitioners deducted in its entirety from their income tax return alleging the fee was entirely for services relating to tax matters. The Commissioner contended that

124 Boone v. United States, 482 F.2d 417 (5th Cir. 1973).
126 Treas. Reg. § 1.212-1(b)(1).
129 60 T.C. No. 23 (May 8, 1973).
Revenue Ruling 72-545,\textsuperscript{130} which dealt with the allocation of legal fees in connection with a divorce proceeding, was applicable to the present situation. Thus, the court interpreted their function as one of allocating the portion of the legal fees attributable to tax advice.

The attorney’s bill was not itemized and his testimony did not indicate the amount of time spent on tax considerations in preparing the estate plan. Although the petitioners failed to carry their burden of establishing what portion of the fee was allocable to tax advice,\textsuperscript{131} the majority of the court was not prepared to accept the Commissioner's contention that the failure made an allocation impossible. The court was convinced by the attorney's testimony that “a significant portion of his services consisted of tax advice.” However, the court was of the opinion that because of the vagueness of the testimony the allocation must be “weighed heavily against the taxpayer,” and allowed only a 20 percent deduction.

The majority opinion suggests that if the attorney’s bill was itemized or if the testimony was more specific a greater deduction could have been obtained.\textsuperscript{132} Three concurring justices suggested that a further deduction was possible under Section 212(2) as the estate planning advice was for the management of property held for the production of income.

The opinion of the four dissenting justices in Merians must not be overlooked. They first struck down the suggestion that a Section 212(2) deduction was possible because they did not believe the services had an effect on the income-producing property itself. They further were of the opinion that the only deductible service performed under Section 212(3) was the filing of the gift tax return. All of the other services were considered by the dissenters to be for future events and as such were not deductible.

Regarding the deductibility of legal fees by a corporation when a tax-free liquidation under Section 337 is involved, there is a division of authority among the circuits.\textsuperscript{133} The Tax Court in \textit{Of Course, Inc.},\textsuperscript{134} a late 1972 decision, allowed a deduction since appeal was to the Fourth Circuit which previously decided legal fees are deductible. The Tax

\textsuperscript{130} 1972-2 \textsc{cum. bull.} 179.
\textsuperscript{131} See Arthur D. McDonald, 52 T.C. 82 (1969); George L. Schulitz, 50 T.C. 688 (1968), \textit{aff'd per curiam}, 420 F.2d 490 (3rd Cir. 1970).
\textsuperscript{132} \textit{Cf.} Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964), wherein a 70% allocation for tax advice towards a divorce and separation was upheld by the Court of Claims.
\textsuperscript{133} United States v. Mountain States Mixed Feed Company, 365 F.2d 244 (10th Cir. 1966); Pridemark, Inc. v. Comm'r, 345 F.2d 35 (4th Cir. 1965), where the deduction was allowed. Connery v. United States, 460 F.2d 1130 (3d Cir. 1972); Lanrao, Inc. v. United States, 422 F.2d 481 (6th Cir. 1970), \textit{cert. denied}, 398 U.S. 928 (1970); United States v. Morton, 387 F.2d 441 (8th Cir. 1968); Alphaco, Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967), where the deduction was disallowed.
Court indicated that if the issue was to be decided without precedent, no deduction would be allowed. They would treat the legal fees as a reduction of the selling price of the corporate assets since they relate to the liquidation, not to doing business.

5.05 Employment Agency Fees. Treasury Regulations under Section 212 disallow "expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation..." However, Revenue Ruling 60-223, which revokes Revenue Ruling 60-158, states that deductions will be permitted for fees paid to employment agencies for securing employment.

The Commissioner prevailed in Eugene A. Carter where the Tax Court determined that expenses incurred by an officer in the United States Air Force in seeking post-retirement employment were not deductible and that Revenue Ruling 60-223 was intended to permit a deduction only when the employment agency actually secures a position for the taxpayer. The court relied on McDonald v. Commissioner for the proposition of law that Section 162(a) confines deductible expenses "solely to outlays in the efforts or services... from which the income flows." Since the taxpayer was an officer at the time of the expenditures, there was no relation of the expense to his income from the Air Force.

In David J. Primuth a deduction was permitted for $3,016 of the expenses paid to Frederick Chusid & Co. for services rendered relative to obtaining a new position as secretary-controller with the Symons Manufacturing Co. Prior to seeking a new position taxpayer was employed as secretary-treasurer of Foundry Allied Industries. The court held that the expenditure was incurred by taxpayer "in carrying on his trade or business of being a corporate executive," and therefore was deductible under Section 162. The court also rejected a distinction suggested by the IRS that fees are deductible only when they are contingent upon securing a job and not deductible if the fee was payable whether or not a new job was located. This was held to be a distinction without a difference.

The Tax Court in Guy R. Moto reaffirmed its position as stated in Primuth. Then in Kenneth R. Kenfield a deduction was allowed for employment agency fees where taxpayer accepted a job offer through

135 Treas. Reg. § 1.212-1(f).
139 1960-1 CUM. BULL. 57 (1960).
140 McDonald v. Comm'r, 323 U.S. 57, 61 (1944).
the agency's efforts, but did not take the job since his present employer increased his salary.143

However, in Morris v. Commissioner144 the Ninth Circuit distinguished "between expenses incurred in seeking and preparing for new work, which are not deductible, and expenses incurred in securing and performing such work, which, of course are deductible."145 Here, since the employment agency was not instrumental in obtaining employment for the taxpayer, no deduction was allowed. Although the taxpayer originally based his claim on both Sections 162 and 212, the case was finally submitted for argument and decided under Section 212.

Revenue Ruling 71-308146 affirmed the Treasury's position that a deduction is permitted only if the taxpayer is successful in securing new employment. Leonard F. Cremona147 engaged a consulting firm to assist in locating a new position. At all times during the unsuccessful search the taxpayer was employed at his old job. The Tax Court was unable to distinguish Cremona from Primuth, Moto or Kenfield and concluded that an administrator, as well as a corporate executive or engineer, could be engaged in a trade or business and therefore could deduct employment agency fees incurred in an attempt to better himself.

In Miller v. United States148 the district court held that employment agency fees paid by an unemployed executive who remained jobless at the time of payment were not deductible as a business expense under either Section 162 or Section 212. The decision turned on the issue of whether or not the expenditures were incurred in carrying on a trade or business.

The court decided it was impossible for the taxpayer to be involved in carrying on a trade or business when he was out of work at the time. Here the court relied on the Ninth Circuit decision in Morris and in effect reinstated the seeking versus securing distinction.

In the author's opinion Miller was incorrectly decided, a taxpayer does not cease to be engaged in carrying on a trade or business merely because he has become unemployed.149 Also, it is important to note that

144 Morris v. Comm'r, 423 F.2d 611 (9th Cir. 1970), aff'd, 36 P-H TAX CT. MEM. 1424 (1967).
145 Id. at 612.
147 Leonara F. Cremona, 58 T.C. 219 (1972).
149 Furner v. Comm'r, 393 F.2d 292 (7th Cir. 1968). Holding that a professional teacher, who took a year to obtain an advanced degree, was engaged in carrying on a trade or business. Harold Haft, 40 T.C. 2 (1963). Holding that a jewelry salesman who worked for 25 years did not cease to be in the jewelry business simply because he was temporarily unemployed and had no merchandise to sell,
the IRS removed employment agency fees from its list of Prime Issues during 1973.

It should be kept in mind that a taxpayer is required to itemize his deductions to be entitled to a deduction for employment agency fees.\(^{150}\)

5.06 Moving Expense. A deduction is allowed for certain expenses incurred in moving during the taxable year in connection with the commencement of work by the taxpayer. In *Hartung v. Commissioner*\(^{151}\) the taxpayer was denied a deduction for unreimbursed moving expenses under Section 217. The deduction was denied as the taxpayer was moving to Australia where his earnings would be exempt from federal income tax. Likewise, *Markus*\(^{152}\) was denied his moving expense deduction since the deduction would offset tax-exempt income earned while abroad.

Another taxpayer, Larry R. Adamson,\(^{153}\) was unsuccessful in his various attempts to bring expenses within the provisions of Section 162. Adamson was an attorney and a certified public accountant living in San Francisco who left California and went to New York for nine months to complete an L.L.M. program in taxation. Upon completion of his degree, the taxpayer moved to Tucson, Arizona, to practice law.

Adamson claimed as deductions under Section 162 the following: (1) The amounts expended for travel, meals and lodging while at New York University for the L.L.M. program. These amounts were claimed as expenditure incurred while away from home to obtain education in his field. The deduction was denied on the basis that the taxpayer had severed his ties with San Francisco, that he incurred no additional expenses, and that his residence for tax purposes was now New York; (2) Transportation expenses from New York to Tucson, at the rate of 12 cents a mile. The court determined the expenses were moving expenses and were deductible only at the rate of 6 cents a mile, and (3) Expenses incurred in gaining admission to the bar of a second state. The deduction was again denied, this time on the basis that the benefits gained were of an indefinite duration and were therefore capital expenditure, not business expenses.

5.07 Education Expense. As a general rule education expenses are deductible if the education:

(1) Maintains or improves skills required by an individual in his employment...or (2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulation,


\(^{151}\) Hartung v. Comm'r, 484 F.2d 953 (9th Cir. 1973).

\(^{152}\) Markus v. Comm'r, 486 F.2d 1314 (D.C. Cir. 1973).

imposed as a condition to the retention by the individual of an established employment relationship, status or rate of compensation.\textsuperscript{154}

Conversely no deduction is permitted if the education fulfills a general aspiration, meets the minimum educational requirements of the trade or business or qualifies the taxpayer for a new trade or business.\textsuperscript{155} Obtaining an undergraduate degree is usually considered a personal expense in order to fulfill a general educational aspiration and, therefore, is not deductible.

However, The Reverend John D. Glasgow was able to sustain the burden of proof and convince the court to allow a deduction for $2,779 of tuition, transportation and other expenses incurred while attending an undergraduate program.

The reasons stated by the court for allowing the deductions were:

(A) he was ordained several years before commencing his education; (B) his education extended over nine years while he devoted his primary attention to the pastorate; (C) he did not obtain a teaching certificate which was normally awarded to graduates of Southern State College; (D) he took courses which would be beneficial to him as a minister; (E) he selected his major in his last year of college merely as a condition precedent to graduating, and (F) his congregation urged him to continue his education and his salary had actually decreased during the three years preceding the trial compared to his salary ten years ago.\textsuperscript{156}

The course of study undertaken by Pastor Glasgow had a direct and proximate relationship to the skills required by the taxpayer in his employment. This situation is in contrast with Mr. Carroll, a Chicago police officer, who was denied a deduction for expenses incurred while obtaining an undergraduate degree because his primary purpose was to meet the prerequisites for admission to law school and to enter the profession of law.\textsuperscript{157}

We should note that this case was decided under the 1958 Regulations which required the expenditures to be undertaken primarily for the purpose “[m]aintaining or improving skills.”\textsuperscript{158} It appears the result of this fact situation should be the same even if decided under the 1967 amendments to the Regulation, which disallow expenses that maintain or improve skills if they are necessary to meet the minimum requirements of a job or qualify a taxpayer for a new trade or business.\textsuperscript{159}

\textsuperscript{154} Treas. Reg. § 1.162-5(a).
\textsuperscript{155} Treas. Reg. § 1.162-5(b) (2) & (3).
\textsuperscript{157} Carroll v. Comm'r, 418 F.2d 91 (7th Cir. 1969).
\textsuperscript{159} Treas. Reg. § 1.162-5.
In 1973 Messrs. Gore, Wright, Lunsford, Ruddy and Melnik were apprised of the fact that the 1967 amendment to the Treasury Regulations, disallowing educational expenses which qualify a taxpayer for a new trade or business, has virtually eliminated any possibility of deducting costs incurred in obtaining a law degree.

An analysis of cases decided since Treasury Regulation 1.162-5(d) was amended in 1967, reveals that law school expenses cannot be deducted by one who is enrolled in a full-time degree program. However, it is the author’s opinion that tuition for certain individual work-related courses may be deductible. The Commissioner’s brief in Carroll v. Commissioner stated: “a currently employed taxpayer such as petitioner might be allowed to deduct the cost of college courses which directly relate to the duties of his employment.”

5.08 Education Expense—Travel. The Treasury Regulations permit a deduction for travel as a form of education expense if it is directly related to the taxpayer’s trade, business or employment. Revenue Ruling 64-176 liberalized the more restrictive 1958 Regulations to permit deductions for sabbatical leave travel if it “has a direct relationship to the conduct of the individual’s trade or business.” Most of the litigation in this area involves teachers attempting to deduct educational travel expenses incurred during summer vacation or while on sabbatical leave.

The basic issue which the courts must determine in these situations is whether the travel is directly related to improving and maintaining the taxpayer’s individual skills or whether it is primarily related to the taxpayer’s personal goal of broadening his prospective through travel, sightseeing, social visiting and recreation.

Mrs. Krist, a first-grade teacher, was not allowed to deduct the cost of her six-month tour of fifteen countries in Europe and Asia by freighter around the African Coast. The court determined that the trip, although having some educational value, was not directly related to improving the taxpayer’s skills as a first-grade teacher. The court noted that Mrs. Krist visited classrooms during parts of five days, that she used pictures, costumes, dolls and games obtained during the trip in her classroom.

163 Ruddy v. Comm’r, 474 F.2d 1342 (9th Cir. 1973).
165 Carroll v. Comm’r, 418 F.2d 91, 95 (7th Cir. 1969).
166 Treas. Reg. § 1.162-5(d).
169 Treas. Reg. § 1.162-5(c).
presentations, and acquired the technique of using a slate and abacus.\textsuperscript{170} Although travel may be "directly related" to teaching duties, this is not sufficient unless it develops or improves a specific area of knowledge which is vital to the taxpayer's position.\textsuperscript{171}

Likewise, Ms. Cochran's $5,283.87 of expenses for a round-the-world tour were not deductible because "cultural enrichments of a teacher and incidental benefits to the students are not sufficient to satisfy that test."\textsuperscript{172} The court noted that while an extensive diary was prepared, it failed to include any references to any teaching methods learned on the trip.

Mr. and Mrs. Elsner, graphic-art teachers at San Jose State College, were denied a deduction for travel expenses incurred in Europe during a six-month leave of absence. The court determined that the taxpayer's activities differed little from those of the normal tourist and hence taxpayers did not sustain the burden of proving that their activities maintained or improved their skills as graphic-arts instructors.\textsuperscript{173}

In \textit{Ford v. Commissioner}\textsuperscript{174} the taxpayer was allowed a business expense deduction for travel, tuition, food and lodging incurred while enrolled in graduate courses in Norway. The curriculum, language, anthropology, and culture were directly related to his skills as a teacher.

It becomes clear that in order to qualify travel as an educational expense, the travel must relate directly to the teaching position held and be fully documented.

5.09 \textbf{Lobbying Expense—Public Employee.} The Tax Court in \textit{James M. Jordan},\textsuperscript{175} a case considered to be one of first impression, permitted taxpayer to deduct lobbying expenses. The taxpayer was employed as a chemist for the Georgia Highway Department and, in 1967, he and five other employees organized the Georgia Highway Employees Association (GHEA). The stated purpose of the organization was to increase wages and to form a grievance committee which would consider the possibility of extending the State Merit System to the Highway Department. Taxpayer, using his own funds, published and mailed a newsletter, made phone calls and traveled to conferences with other GHEA members and various legislators.

The court found that taxpayer's expenses met the requirements of Section 162(e). The requirements for deducting lobbying expenses are as follows: (A) incurred in carrying on a trade or business;

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\textsuperscript{170} Krist v. Comm'r, 483 F.2d 1345 (2d Cir. 1973).
\textsuperscript{174} Ford v. Comm'r, 32 Am. Fed. Tax R.2d 73-6121 (9th Cir. 1973).
\textsuperscript{175} James M. Jordan, 60 T.C. No. 80 (August 27, 1973).
\end{flushright}
(B) ordinary and necessary; (C) relate to legislation which is of sufficient direct interest to the taxpayer, and (D) be in connection with communications, appearances and submission of statements to legislative bodies or political subdivisions.

The court found that "[P]etitioner's trade or business is being an employee of the Georgia Highway Department." The expenditures were ordinary and necessary in that although the typical employee may not incur this type of expense, they are of a nature which normally would be incurred in a lobbying effort and they were related to communications and appearances before legislatures.

To determine the question of direct interest, the court looked to the Treasury Regulation, which states "[L]egislation or proposed legislation is of direct interest to a taxpayer if the legislation or proposed legislation is of such a nature that it will, or may reasonably be expected to, affect the trade or business of the taxpayer." Since the taxpayer's efforts, if successful, would result in increased compensation and improved working conditions, the direct interest test was satisfied.

5.10 Substantiation Rules for Travel, Entertaining and Gift Expense. Included in the phrase "ordinary and necessary business expense" are expenditures for travel, entertaining and business gifts. Although these expenditures are deductible from gross income, a serious problem arises as to the manner of proof thereof, and as a result the taxpayer and the IRS have been engaged in a continuing battle. The taxpayer normally deducts expenses in excess of the amounts he can actually substantiate by producing receipts, etc.

In 1930 the Second Circuit Court of Appeals recognized the problem and established what became known as the Cohan Rule. George M. Cohan, entertainer and producer, deducted $55,000 for travel and entertaining expenses incurred during a three-year period. The lower court allowed no deduction since Cohan was unable to prove any amount of expense, since no details or records were maintained by the taxpayer. The appellate court ordered the lower court (Board of Tax Appeals) to:

[M]ake as close an approximation as it can, bearing heavily upon the taxpayer whose ineractitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for his computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was some basis for some

176 Id.
177 Treas. Reg. § 1.162-20(c), (2), (ii), (b), (1), (i).
178 Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930).
allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative.\textsuperscript{179}

The Cohan Rule continued to be the guiding light for resolving disputes involving travel, entertaining and business gift deductions until 1962.

In 1962 Congress enacted Section 274 to curb extensive expense account abuses. Section 274(d) disallows travel, entertaining and business gift expenses unless the taxpayer meets the strict substantiation requirements as to: (A) the amount of the expense, (B) the time and place, (C) the business purpose, and (D) the business relationship. The taxpayer is required to substantiate the expense either by adequate records or by sufficient evidence corroborating his own statement.

Treasury Regulation 1.274-5(c) requires "adequate records" such as an "account book, diary, statement of expense or similar record." If the taxpayer does not meet the requirement of adequate records, then he must prove the elements of the expense by a written statement and other corroborative evidence. Based on the aforementioned regulations the IRS insisted on written evidence as a condition precedent to allowing a deduction for travel, entertaining and business gifts.

Dr. La Forge, a surgeon at Buffalo General Hospital purchased lunches for himself and the interns and residents who worked with him. The cost ranged from $2.65 to $3.00 per day and Dr. La Forge deducted $2.00 for each day he was at the hospital. Unfortunately he maintained no records and the hospital cashier was not permitted to give receipts. As a result, his expenses were disallowed since he could not meet the substantiation requirements. The Tax Court upheld the Commissioner's contention that Dr. La Forge had failed to maintain "adequate records" and disallowed the deductions.\textsuperscript{180} On appeal the Second Circuit held: "To require a written statement itemizing each expenditure is, in effect, to compel the taxpayer to maintain 'adequate records' and thereby to dismiss from the statute one element of its disjunctive substantiation requirements."\textsuperscript{181} Further, the Treasury Regulation\textsuperscript{182} was contrary to the Congressional intent.\textsuperscript{183}

On December 15, 1972, Treasury Decision 7226\textsuperscript{184} was filed amending Treasury Regulation 274-5(c)(3)(i) by striking the words "in writing" and inserting the phrase "whether written or oral."

\textsuperscript{179} Id. at 544.
\textsuperscript{180} Harry G. LaForge, 53 T.C. 41 (1969).
\textsuperscript{182} Treas. Reg. § 1.274-5(c)(3).
\textsuperscript{183} S. REP. No. 1881, 87th Cong., 2d Sess. (1962).
\textsuperscript{184} T.D. 7226, 1973 INT. REV. BULL. No. 3 at 6.
While La Forge and T.D. 7226 represent decisive victories for taxpayers, cases subsequent to La Forge make it clear that "Even though a written statement may not be required for substantiation, the corroborative evidence must nevertheless establish each statutory element—amount, time, place and purpose—of the expenditure with precision and particularity." 185

5.11 Research and Development Expense. Section 174 186 allows taxpayers an option of whether to capitalize or expense expenditures for research and development. A condition precedent to the electing to expense research and development is that the expenditures be incurred in connection with carrying on a trade or business. To answer the question of what is a trade or business we turn to Justice Frankfurter's decision in Deputy v. DuPont where it was defined as "holding one's self out to others as engaged in the selling of goods or services." 187 This definition was adopted by the Fourth Circuit 188 and expanded by the Fifth Circuit 189 to cover "extensive activity over a substantial period of time." 189

In Snow v. Commissioner 180 the taxpayer, a $200,000-a-year executive vice president for Procter & Gamble, participated through a limited partnership in the development of a trash-burning device. Snow also invested in two other companies. The IRS disallowed the deduction since they determined Snow was not engaged in a trade or business, and therefore the expenditures were nondeductible pre-operating expenses. This opinion was affirmed by the Tax Court.

The taxpayer relied upon the Congressional intent for Section 174 to equalize small companies with major corporations. 191 After further analysis the court found that this intent only applies to those engaged in a trade or business. The remaining issue is whether the taxpayer, by investing in several companies which were not at the time selling goods or services, was engaged in trade or business. Relying on the Supreme

185 Hughes v. Comm'r, 451 F.2d 975, 979 (2d Cir. 1971).
Research and experimental expenditures
(a) TREATMENT AS EXPENSES—
(1) In general.—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.
188 Helvering v. Highland, 124 F.2d 556 (4th Cir. 1942).
189 Stanton v. Comm'r, 399 F.2d 326, 329 (5th Cir. 1968).
191 97 CONG. REC. 4326A (1951) (Remarks of Representative Camp). "[T]o prevent tax discrimination between large business having continuous programs of research and small or beginning enterprises...."
Court's decision in Whipple v. Commissioner\textsuperscript{192} the Sixth Circuit determined that Mr. Snow, by merely investing as a minority shareholder in several businesses was not engaged in a trade or business, hence the expenditures were not deductible under Section 174.

5.12 Partnership Expenses—Who May Deduct. Is a partner in a law firm permitted to deduct expenditures made on behalf of the firm on his personal tax return if he is not reimbursed by the firm? The question can be answered in the affirmative if the partnership agreement has been carefully drafted so as to require individual partners to assume responsibility for certain expenses. If the partners have been negligent and have not covered this matter in the agreement, an alternative remains, if a partnership practice of payment by partners can be established.\textsuperscript{193} Of course, the burden of proving the practice falls upon the taxpayer.

In Tonkoff v. United States the taxpayer was denied a deduction for reimbursed expenses of operating his aircraft and other travel and entertainment expenses because “the record is [was] devoid of evidence of a partnership understanding, agreement, or a clear course of conduct which would bring plaintiff within the Klein holding.”\textsuperscript{194} This case presents a caveat not only to members of a partnership but also to corporate executives; since, an employee is not entitled to a deduction for any expenditure relative to corporate business if he is entitled to reimbursement from the corporation. To eliminate this issue an agreement should clearly spell out the partners' or executives' responsibilities for personal payment of certain expenses. Another possibility for partners is to have the partnership pay all expenses and to allocate all such expenditures to the incurring partner, of course providing for this arrangement in the partnership agreement.

Although unrelated to the deduction of business expenses, Attorney Tonkoff contended that the government owed him for rental of office space and for secretarial services incurred by the revenue agent during the audit. Unfortunately the court was unable to find any basis in


Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation... If full-time service to one corporation does not alone amount to a trade or business, which it does not, it is difficult to understand how the same service to many corporations would suffice.

\textsuperscript{193} Klein v. Comm'r, 25 T.C. 1045 (1956).

jurisdiction or in law to sustain taxpayer's claim. While we may smile as to Attorney Tonkoff’s contention, when we consider the space required for revenue agents examining a large corporation over an extended period of time the issue of renting office space and equipment to the IRS takes on more importance. It is the author's opinion that if the rental issue was sufficiently pressed, the agents would react by merely requesting the corporate executive to transport all material, books, ledgers, etc., to the local field office.

5.13 Business Expenses—Future Reimbursements. Harry M. Flower entered into an agreement whereby he would be the exclusive sales representative in several counties of southwest Texas. The agreement provided for the employer to reimburse Flower in 1985 for all expenses incurred during a ten-year period developing the sales territory. The contract also provided for earlier reimbursement dependent upon Flower's death, disability or voluntary retirement. During the years in question the taxpayer, relying on Section 162(a) deducted the expenses incurred in working the territory. However, on audit the expenses were disallowed.

The Tax Court upheld the IRS's disallowance based on the well-established principle “that where taxpayer makes expenditures under an agreement that he will be reimbursed therefore, such expenditures are in the nature of loans or advancements and are not deductible as business expenses.” This rule is applicable when the right to be reimbursed is contingent and advances “made only with the expectation that they would be substantially repaid.”

5.14 Used Tires and Tubes. Revenue Ruling 59-249 provides that the cost of tires and tubes purchased on new commercial trucking equipment is an ordinary business expense and deductible in the year of purchase. This ruling has been extended to allow the tires and tubes on used construction equipment purchased to be expensed if the useful life is less than one year. Revenue Ruling 73-357 only relates to used construction equipment but the same allowance would seem to apply to used commercial vehicles of all types. If the useful life of the tires and tubes is less than one year and the taxpayer can substantiate the allocation

196 Id. See Canelo v. Comm'r, 447 F.2d 484 (9th Cir. 1971), aff'g, 53 T.C. 217 (1969); Joseph C. Patchen, 27 T.C. 592 (1956).
197 Burnett v. Comm'r, 356 F.2d 755, 760 (5th Cir. 1966). See also Levy v. Comm'r, 212 F.2d 552 (5th Cir. 1954); Universal Oil Products v. Campbell, 181 F.2d 451 (7th Cir. 1950).
5.15 **Unreasonable Salary.** Section 162 provides for a deduction of all the ordinary and necessary expenses paid during the taxable year including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The Regulations provide that the compensation paid may not exceed what is reasonable under the circumstances; whether or not the compensation is reasonable is a question of fact.

In *Langley Park Apartments, Inc. v. Commissioner*, the Fourth Circuit affirmed a Tax Court decision limiting the amount of compensation payable to the president and vice-president of a corporation who had few duties to perform as a management firm ran the business. The court in *Perlmutter v. Commissioner*, upheld the Commissioner's determination that the salary paid to the president and sole stockholder was unreasonable and thus not an allowable business expense for the corporation. The taxpayer argued that the payments were proper as compensation for past services. The court found no evidence in the record to support this allegation, but presumably would have given consideration to such an argument if properly substantiated.

A late 1972 decision, *Dave Fischbein Manufacturing Co.*, determined that the salary paid to the 80-year-old chairman of the board and former president was reasonable even though he had suffered a stroke and was in a rest home. The court appeared to rely heavily upon Mr. Fischbein's long and dedicated service to the corporation and that his salary of $20,800 had remained constant since 1953. On March 12, 1973, the Commissioner acquiesced in the *Fischbein* decision.

On April 30, 1973, the Commissioner also acquiesced in the Tax Court's decision in *R. J. Nicoll Co.*, decided in October, 1972. In *Nicoll* the court determined that the compensation of $11,500 for nine months of 1965, $15,000 for 1966 and $11,500 for 1967 could not be

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200 INT. REV. CODE OF 1954, § 162. "(2) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

201 Treas. Reg. § 1.162-7(b) (3).

202 *Perlmutter v. Comm'r*, 373 F.2d 45 (10th Cir. 1967).


204 *Perlmutter v. Comm'r*, 373 F.2d 45 (10th Cir. 1967).


supported as being reasonable based on the testimony submitted by the taxpayer's witnesses and the limited amount of work performed by Mr. Nicoll for the corporation during the years in question. However, when the reasonableness of compensation is in issue the court may look not only to the current years but also to previous years. During earlier years Mr. Nicoll worked for the predecessor's corporation of R. J. Nicoll Co. for a salary ranging from $9,000 to $12,000 when the reasonable worth of the services was $15,000 to $18,000. Undercompensation was due to efforts to maintain liquid assets within the corporation so as to permit growth. Furthermore, during the growth years Mr. Nicoll worked from dawn to dark six or seven days a week. The salaries were held to be reasonable in 1965 and 1967, and the 1966 reasonable salary was held to be $11,500 instead of the $15,000 actually paid.

While the cases present taxpayers with persuasive arguments for use in unreasonable compensation cases when the fact situation applies, it should be remembered that here salary levels were relatively low both for the current and prior years.

5.16 Farms—Prepaid Feed. Over the years Congress has been kind to farmers and as a result they have been afforded certain tax benefits such as expensing costs which would otherwise be capitalized and being permitted to prepare tax returns on a cash basis while maintaining records on the accrual basis. A problem arises when an attempt is made to determine who is a farmer and what is actually a farm. Treasury Regulation 1.64-4(a) defines a farm as follows:

[T]he term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers...

208 Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930); John C. Nordt Co., 46 T.C. 431 (1966), acquiesced as to this issue, 1972-2 CUM. BULL. 2; General Smelting Co. 4 T.C. 313 (1944).


A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay. . . .

210 Treas. Reg. § 1.471-6(a).

A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

211 Treas. Reg. § 1.61-4(d).
In *Hi-Plains Enterprises, Inc.*, the taxpayer successfully contended he was a farmer. The taxpayer operated a feedlot where both its own cattle and cattle of other owners were fed for four to five months prior to sale. By the end of 1968, 22,709 head of cattle, 5821 of which were owned by taxpayer, were being fed. The taxpayer believed it was required to maintain corporate records on the accrual basis of accounting to comply with Securities and Exchange Commission requirements. However, the federal tax returns, relying on Treasury Regulation 1.471-6(a), were filed on cash basis. Because of the election the taxpayer was able to expense the cost of feed on hand at the end of each taxable year (which otherwise would have been considered inventory and not expensed until consumed).

In upholding the taxpayer's methods the Tax Court looked to *W. P. Garth*, *United States v. Chemell* and *W. Cleve Stokes*, holding that a poultry hatchery business and a nursery were farms. Consistent with this the IRS considers feed lots farms for the purpose of F.D.C.A. and Section 6420 relating to payments for gasoline used on farms. This case has been appealed by the government to the Tenth Circuit.

The Treasury announced it planned to issue Revenue Ruling 73-530 dealing with the deduction of prepaid feed costs by cash-basis farmers. The proposed Ruling sets forth the following threefold test that expenditures must meet as a condition precedent to obtaining a deduction: "Expenditure must be a payment and not a deposit; the prepayment must be made for business purposes, and not merely tax avoidance and; deduction must not result in material distortion of income." Publication will be delayed as an injunction is pending in the District Court for Western District of Oklahoma. However, in the interim the IRS will continue its interpretation of the law as set forth in TIR 1266. The Revenue Ruling 73-530 was to strictly limit the popular rollover tax shelter whereby cattle feeders prepay extensive amounts for feed to be consumed in a future period, and acquire an immediate tax deduction in the year of payment.

The Treasury will disallow the expenditure if it is determined to be a deposit. A deposit is evidenced by the absence of specific guaranties and a right to a refund for the unused portion. Two illustrations provided of valid business reasons for the prepayment are to assure a source of supply or to set a maximum price. If the taxpayer successfully completes

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214 *United States v. Chemell*, 243 F.2d 944 (5th Cir. 1957).
the first two requirements he still must satisfy the Commissioner that he
has not distorted income as defined in Sections 461(a) and 446(b).

The Treasury appears to have had Hi-Plains Enterprises in mind
when drafting the proposed ruling as reference is specifically made to
his own livestock in setting forth the requirements for the deduction. It is
submitted that the reference to the taxpayer's "own livestock" is intended
to preclude a deduction for prepaid feed for cattle belonging to others
which he is in the business of feeding.

The issue of prepaid feed expenses of a cash-basis hog farmer was
appealed to the Eighth Circuit in **Mann v. Commissioner**. The Tax
Court denied a deduction because the supplier could not physically supply
all the feed purchased, price reductions would inure to the benefit of the
farmer and the farmer could substitute other types of feed, and
the payment was not an ordinary and necessary business expense. On
appeal the Eighth Circuit reversed, holding the payment was pursuant to
a valid binding contract which guaranteed maximum prices, not merely a
refundable deposit, and also guaranteed a supply at a time when the crop
conditions for the next year were unknown. As a result the expenditures
were an ordinary and necessary business expense.

Because of these factors the Securities and Exchange Commission
now requires that any prospectus for an offering of a livestock feeding
tax shelter program must state the position of the IRS on the deductibility
of prepaid feed costs. The prospectus must also note that such a
position would substantially reduce any intended tax deferral benefit
of such an investment.

5.17 **Intangible Drilling Costs.** Section 1263(c) and Treasury Regulation 1.612-4 provide for the election to immediately expense the
intangible drilling and development costs incurred by one who holds a
working or operating interest in oil or gas properties. "This option applies
to all expenditures made by an operator for wages, fuel, repair, hauling,
supplies, etc., incident to and necessary for the drilling of wells and
preparation of wells for the production of oil or gas."220

Under the typical arrangement the taxpayer-investor enters into a
contract with an oil producer or operator to drill an individual well or
to develop a certain oil or gas lease. The contract specifies the amount of
the intangible drilling cost. If the driller strikes oil or gas the investor
pays additional costs to complete, equip and prepare the well for
production proportionate to the fractional working interest.

The taxpayer deducts the intangible drilling cost on his current
federal tax return and considers the completion costs as his basis in

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his working interest. If the operator has the unconditional right to negotiate with a drilling contractor and he enters into a contract with a drilling company, which he controls, for a price in excess of the price which would have been arrived at in an arm's length transaction, then Revenue Ruling 73-211 treats the excess as an investment in the working interest and disallows any deduction of the excess.

5.18 Medical Deductions. Prior to 1973, the IRS took the position that birth control pills were not deductible as a medical expense unless childbirth was a threat to the woman's life. Revenue Ruling 73-200, which supersedes Revenue Ruling 67-339, provides that the IRS will recognize the cost of birth control pills prescribed by a physician as a medical expense deduction under Section 213(e). Although the deductibility of other birth control methods and devices is not discussed by Revenue Ruling 73-200, it is the author's opinion that these items should also be deductible.

Another development relative to the problem of birth control was covered by Revenue Ruling 73-201 which authorizes a medical expense deduction for abortions and vasectomies. The requirement of the Treasury Regulation that the operation be legal under state law, is carried forward into the Revenue Ruling. The reasoning behind allowing these medical deductions is that both operations are deemed to be for the purpose of affecting a structure or function of the body.

The Code authorizes a deduction for insurance premiums applicable to medical expenses for the taxpayer's family if the premium is separately stated. Revenue Ruling 73-483 states that even though the premium for the medical payments portion of automobile insurance is separately stated, no deduction is allowed since the medical payments premium covers all occupants of the automobile. To be deductible, the premiums would have to separately state the portion of the medical insurance premiums applicable to the taxpayer, his spouse and dependents.

In Revenue Ruling 72-593, a late 1972 ruling, the Treasury recognized that acupuncture treatments rendered in connection with the diagnosis, cure, mitigation, treatment, or prevention of disease qualify for the medical expense deduction.

221 Rev. Rul. 73-211, 1973 INT. REV. BULL. No. 19, at 5.
225 Treas. Reg. § 1.213-1(e) (ii).
226 Treas. Reg. § 1.213-1(e) (ii).
227 INT. REV. CODE OF 1954, §§ 213(e) (1) (c) and 213(e) (2).
Revenue Ruling 73-189 authorizes the donor or a prospective donor of a kidney to deduct all hospital, surgical, laboratory, and transportation expenses relating to the transplant operation. These expenses are deductible as medical expenses even if tests indicate the prospective donor is not acceptable.

The Treasury has previously ruled that transportation expenses incurred by a taxpayer to attend Alcoholics Anonymous Club meetings and the cost of maintaining a dependent in a therapeutic center for drug addicts qualify as medical deductions. Revenue Ruling 73-327 permits a deduction for treatment expenses, including meals and lodging, incurred by a taxpayer while living for several months at a therapeutic center for alcoholics.

The Treasury has proposed an amendment to the Regulation which authorizes a medical expense deduction for a capital expenditure to the extent the expenditure exceeds the increase in the value of the property. The proposed amendment provides that maintenance and operating expenses incurred in connection with the capital expenditure are currently deductible provided the medical reason for the expenditure continues to exist.

5.19 Interest—Tax-Exempt Securities. No deduction is permitted for interest paid on indebtedness incurred in purchasing securities if the income resulting from these obligations is wholly tax exempt. Where the indebtedness is traceable to the purchase of tax-exempt securities by a dealer in such securities, or where a brokerage business deals in both exempt and non-exempt securities and the use of the borrowed funds cannot be directly traced (so that an inference arises that the borrowed funds were used for all facets of the business) the deduction will be denied.

This rationale was applied and extended in James C. Bradford. The petitioner had borrowed funds daily to conduct its brokerage business, a facet of which involved the purchase of tax-exempt securities. To determine deductibility the Tax Court expressly adopted the Commissioner's

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v. Leslie\textsuperscript{239} "purpose test": "[W]e have concluded that the approach of the Second Circuit... which permits the proscribed purpose to be inferred from a continuous course of conduct involving borrowing and the acquisition of tax exempt securities, represents the better view."\textsuperscript{240}

The logic for the "purpose test" employs simple deduction: if the taxpayer had not held tax-exempt securities its monthly average assets would be decreased proportionately; the taxpayer would incur decreased indebtedness and therefore a decreased interest expense.\textsuperscript{241} Since this decrease in interest expense equates with the expense incurred to purchase exempt securities, an amount equal to the decrease is nondeductible interest expense. The lesson is quite explicit—a proscribed purpose of borrowing to purchase tax-exempt securities will be inferred from a continued course of dealing that involves borrowing and acquisition of such securities.

6.00 Depreciation

6.01 Tax Shelters. The use of depreciation on real property to create a tax shelter is an accepted instrument of efficient tax planning. The trick has always been to achieve the greatest depreciation write-off with the least amount of capital outlay and personal liability. It has long been held that a party who purchases property subject to a mortgage acquires a depreciable interest in the total value of the property even though his actual cash outlay is minimal.\textsuperscript{242} Assuming an individual can obtain the requisite financing, the creation of the write-off poses few problems. However, creation of the write-off without incurring personal liability on the obligation is more difficult to achieve. The limited partnership provides a vehicle to limit personal liability, but even so, the general partner is liable and a partnership is not well suited to individual use.\textsuperscript{243} Subchapter S election would allow the pass-through of losses (depreciation deduction) and afford limited liability to the shareholders, but if real estate rentals are the only activity engaged in by the corporation the passive income limitation will prevent the use of a Subchapter S election.\textsuperscript{244}

\textsuperscript{239} Commissioner v. Leslie, 413 F.2d 636 (2d Cir. 1969), cert. denied, 396 U.S. 1007 (1970).

\textsuperscript{240} James C. Bradford, 60 T.C. No. 30 (May 22, 1973). Accord, Indian Trail Trading Post, 60 T.C. No. 54 (June 27, 1973). Here, petitioner borrowed funds in excess of his current needs and eight months later, purchased tax exempt bonds, while still having cash in excess of needs. The interest deduction was disallowed with the "purpose test" prevailing.

\textsuperscript{241} 413 F.2d at 639.

\textsuperscript{242} Crane v. Comm'r, 331 U.S. 1 (1947); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Manual D. Mayerson, 47 T.C. 340 (1966).

\textsuperscript{243} Perry, Limited Partnerships and Tax Shelters; The Crane Rule Goes Public, 27 Tax L. Rev. 525 (1972).

\textsuperscript{244} INT. REV. CODE OF 1954, § 1372(e) (5).
Through a series of transactions the taxpayer in David F. Bolger was able to achieve both limited liability and individual write-off of the depreciable interest in his investments. The taxpayer followed the same method in ten separate transactions challenged by the Commissioner: (1) Form a financing corporation of the eventual titleholders of the property with minimal capitalization; (2) Arrange to purchase a building that some commercial or industrial concern desired to lease; (3) Usually on the same day (a) convey the property to the financing corporation, (b) the financing corporation would enter a lease with the user, and (c) sell its own corporate notes equal to the purchase price to an institutional lender, the notes being secured by a first mortgage and an assignment of the lease; (4) The corporation would then convey the property to its shareholders for “one dollar and other valuable consideration” subject to the mortgage and the lease, but without a cash payment; (5) The transferees would execute an assumption agreement, assuming all of the financing corporation’s obligations on the lease and the mortgage but limiting their personal liability.

At the conclusion of these transactions the shareholders of the financing corporation held legal title to the property. This interest was depreciable in the amount of the mortgage on the buildings. The lessee, by the lease and mortgage agreements, was primarily liable for the mortgage payments. The financing corporation retained secondary liability on the mortgages, but the shareholders of the financing corporation were not obligated beyond the requirement that the financing corporation be kept in existence. The shareholders reported their proportionate share of the income and the deductions attributable to the properties.

In answering the question whether the taxpayer was entitled to the depreciation deductions three issues are raised: (1) Whether the financing corporations constituted separate viable entities; (2) Whether if they are, are they or the taxpayer entitled to the depreciation deduction; (3) What is the basis of the property?

The Court found three legitimate business purposes for the creation of the corporations: to maximize financing by avoiding state law restrictions on loans to individuals, to provide a mechanism for limiting personal liability, and to facilitate multiple-lender financing. After the transfers of property, the corporations remained liable on their obligations to the lenders and were required to remain in existence. In fact, one of the corporations did participate in refinancing arrangements after the transfer to the shareholders. These facts were held sufficient to find the existence of a separate corporate entity under the test set forth in Moline Properties, Inc. v. Commissioner:

The doctrine of corporate entity fills a useful purpose in business

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245 David F. Bolger, 59 T.C. No. 75 (March 8, 1973),
Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.\(^{246}\)

The Commissioner contended that at the time of the transfer the corporation did not hold a depreciable present interest in the properties. Further, because the lease payments were entirely committed to the mortgage obligations, the corporations could only transfer a reversionary interest in the properties. The court concluded that the taxpayer did receive full legal title and beneficial ownership of the property from the corporation. Since the interest held by the corporations in the properties was depreciable, the interest held by the corporation's transferees was also held depreciable.\(^{247}\)

That a taxpayer's basis in depreciable property includes the amount of any encumbrance on the land even though the taxpayer is not personally liable for the encumbrance was firmly established in *Crane v. Commissioner* and subsequent cases. The Crane doctrine permits the taxpayer to recover his investment in the property before he has actually made any cash investment on the assumption that a capital investment will eventually be made. The taxpayer in *David F. Bolger* was found to have a definite interest in the property as his equity increases as the mortgage is paid and he gains from any appreciation in the value of the land.

The dissenting opinions in *David F. Bolger* raised some valid considerations for anyone attempting a similar venture. First, the step transaction doctrine should have been applied.\(^{248}\) A connected series of transactions must be construed as a single transaction and the internal revenue laws applied to the series as a whole and not its individual parts. There was no legitimate business purpose to the transactions other than to achieve a tax result.\(^{249}\) Second, the real equity in the financing corporations was evidenced by the fractional interests transferred by deed to the shareholders. Since the corporations were stripped of their only asset, the share certificates represented nothing. Third, the income from the rentals should have been taxed to the financing corporations or as income to an entity taxable as a corporation. The assumption agreement bound the transferees together and required them to perform certain business functions, *i.e.*, maintain the corporations and oversee the


\(^{248}\) George A. Nye, 50 T.C. 203, 211 (1968).

\(^{249}\) David F. Bolger, 59 T.C. No. 75 (March 8, 1973). *See also* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
corporate activities. As such they possess the major characteristics of an entity taxable as a corporation under Treasury Regulation 301.7701-2. If the association more nearly resembles a corporation than separate individuals the interest of the taxpayer would be that of a shareholder and taxable as a dividend not income. The corporation would be the only entity with a depreciable interest in the property.

Judge Goffe, dissenting, expressed the actual result achieved by Mr. Bolger:

I conclude that the transfer of title was for the sole purpose of passing on to the individuals a deduction for accelerated depreciation in excess of the income from the property. Furthermore, I do not see how the reporting of income by the individuals adds any strength to petitioners' case. In my view both the income and the deductions belong to the corporation.

I conclude that the transfer of title was nothing more than a device to secure for the petitioners the benefits of Subchapter S status which they could not otherwise enjoy. 250

The Commissioner has indicated the case will be appealed to the Third Circuit. The finding that the financing corporation was a viable corporate entity has been cited in three other Tax Court decisions as to what constitutes such an entity or whether such an entity existed. 251 David L. Bolger was also cited favorably for its finding that the amount of an outstanding mortgage is includable in the basis of depreciable property. 252 If the Third Circuit rules against the Tax Court's decision the most likely finding would be that the association of shareholders, as transferees of the property, is a taxable entity. If a second taxable entity is held to exist the income would be taxable to the entity and more importantly the entity would have the only depreciable interest in the property. Acquisition of a deductible tax loss through the use of accelerated depreciation in excess of rental income was the purpose behind the entire transaction. The creation of a second taxable entity would strip the transaction of its tax advantages.

6.02 Depreciation Method—Federal Power Commission. The Supreme Court granted certiorari to determine whether under the Tax Reform Act of 1969 253 the Federal Power Commission 254 retained the

250 David F. Bolger, 59 T.C. No. 75 (March 8, 1973).
254 Natural Gas Act, 15 U.S.C. § 717(d) (1954). The Natural Gas Act gave the Federal Power Commission the authority to permit or require a utility to change its method of calculating depreciation as part of the Commission's power over fixing rates and charges.
authority to permit a regulated utility to change its depreciation method from an accelerated method to a slower method of depreciation. The Court held the purpose of the Act was to forestall switches to faster methods of depreciation, to guard against rate increases and to enhance the competitive position of some utilities. The “freeze” imposed on the method of depreciation was not absolute and did not prevent the adoption of a slower method of depreciation where requested by a utility.

While the Court found that the Commission did have the power, the exercise of such power was subject to the requirements of the consumer. A change in the depreciation method that resulted in higher rates would be allowable only if the increase was “just and reasonable.” Further, that rates are “just and reasonable” only if consumer interests are protected and if financial health of the pipeline remains strong.

6.03 Public Utility—Construction Equipment. Revenue Ruling 59-380 provides:

Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made a part of the cost of the capital improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

The Supreme Court has granted certiorari to determine whether the Ninth Circuit was correct in deciding that Revenue Ruling 59-380 is an improper and incorrect interpretation of the law. The taxpayer is a utility owning considerable amounts of construction equipment which it uses in the construction of capital assets for its own facilities. In 1962 and 1963 the taxpayer deducted the depreciation on its equipment based on the life of the equipment (ten years) instead of the life of the capital asset (thirty years). The Commissioner disallowed the deduction and contended that Revenue Ruling 59-380 and Southern Natural Gas Co. v. United States were controlling.

Section 167 allows a depreciation deduction on property used in a trade or business. If the taxpayer owning construction equipment is not in

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256 Id. at 1732.
259 Southern Natural Gas Co. v. United States, 412 F.2d 1222 (Ct. Cl. 1969).
260 INT. REV. CODE OF 1954, § 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence). (1) of property used in the trade or business...
the construction business such equipment is not "property used in the trade or business" of the taxpayer and, therefore, under Revenue Ruling 59-380 is not depreciable property. The construction equipment constitutes a cost of construction and under Treasury Regulation Section 1.263(a)-2 is a capital expenditure to be added to the basis of the asset constructed. The Court of Claims approved this application of Section 167 in *Southern Natural Gas Co. v. United States.* The taxpayer in *Idaho Power Co. v. Commissioner* contended that depreciation is not a capital expenditure and that Idaho Power was engaged in the "business" of constructing new facilities. Section 263 specifies those amounts paid out for new buildings or for permanent improvements are capital expenditures. Depreciation is a "decrease in value" not a payment, expenditure, or out-of-pocket expense, and no exception is made under Section 167 because it relates to a capital expenditure.

Contrary to *Southern Gas,* there is no double recovery in *Idaho Power* because the depreciation deduction was not included in capitalization of the asset. Nor is there any danger, as the Court of Claims felt existed that all costs of construction could be expensed if the taxpayer was allowed a separate deduction for the depreciation cost of construction equipment. All items actually paid out for the construction are part of the capital asset and includable in the asset's basis.

A revenue ruling does not have the force of law and to the extent it conflicts with a statute it is ineffective. The taxpayer's interpretation of Sections 263 and 167 is well founded. There does not appear to be any foundation for Revenue Ruling 59-340 and its inclusion of depreciation

262 412 F.2d 1222, 1264 (Ct. Cl. 1969).
263 Id. at 1265.
264 Int. Rev. Code of 1954, § 263. Capital Expenditures. "(a) No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."
265 Massey Motors, Inc. v. United States, 364 U.S. 92 (1959); Orr v. United States, 343 F.2d 553 (5th Cir. 1965); Clinton H. Mitchell, 42 T.C. 953 (1964); Maurice S. Gordon, 37 T.C. 986 (1962).
266 Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1265 (Ct. Cl. 1969).
on construction equipment in the capitalization of an asset. While the useful life of the asset constructed may be thirty years, obviously, the life of the construction equipment is much less. If the taxpayer is to remain in business the equipment will have to be replaced several times before the capital expenditure in the original equipment is recovered. Capitalizing the equipment over the life of the asset constructed would defeat the purpose of depreciation.

6.04 Component Depreciation—Used Buildings. The IRS has changed its position on the use of component depreciation of used buildings. Under Revenue Ruling 66-111 component depreciation of new buildings was permissible but component depreciation of used buildings was prohibited. The ruling was based on the Tax Court holding in *Louis Lesser* that as to a used building the useful life of a component part was "not susceptible of any precise mathematical solution." The ruling agreed with the *Lesser* decision on the determination of component life and asserted that component parts of a used building "are not ordinarily subject to fair market value determinations for allocations of basis or for depreciation purposes." The IRS did not raise the *Lesser* case or Revenue Ruling 66-111 in a 1970 case that approved the component method of depreciation on a used building, *Harsh Investment Corp. v. United States*. Harsh retained a reputable firm of appraisers to allocate the purchase price between the land and the building purchased and to appraise the value and life of the component parts of the building. Nine accounts were established: ceilings, internal construction, roof cover, lighting and wiring, plumbing, heating, ventilating, fire protection and elevators. The government did not seriously contest the method employed.

Revenue Ruling 73-410 sets forth the IRS's new position on component depreciation. Although *Harsh* is not cited in the ruling, the method of component depreciation of used buildings expressed in *Harsh* is basically the position taken by the IRS. The ruling makes one stipulation that if the taxpayer elects to apply Section 1.167(a)-11 of the regulations (ADR provisions) and determines the depreciation for the building under that section, component depreciation may not be utilized.

268 Louis Lesser, 42 T.C. 688 (1964), aff'd, 352 F.2d 789 (9th Cir. 1965).
269 Id. at 706.
Downtown Shopping Mall. Revenue Ruling 73-188\textsuperscript{274} permitted store owners, who were assessed for the construction of a downtown shopping mall, to depreciate the amount of the assessment as a capital expenditure. To enhance the downtown business district, the city enclosed the main street into a mall, issued bonds, and assessed the adjacent property owners for the value of the bonds. Section 164 disallows the deduction, as an expense, of taxes assessed against local property owners for benefits tending to increase the value of the property assessed.\textsuperscript{275} However, such assessments will be considered a capital expenditure if the benefit conferred can be considered to give the business an advantage over competitors. In this case the advantage was expected to continue over a ten-year period, therefore, the “capital expenditure” was depreciable over a ten-year period. The cost of maintaining the mall and that portion of the assessment that is interest expense on the bonds are deductible as business expenses.\textsuperscript{276}

Corporations

Disallowance of Post-Acquisition Losses. Section 269 provides for the disallowance of deductions and losses if the principal purpose of the acquisition was to evade or avoid federal income taxes. The section was enacted in 1943 to prevent the purchasing of loss corporations to offset high profits which were subject to the “excess profits” tax. The offset was accomplished through tax loss carryovers and selling acquired assets with a high tax basis and a low market value.\textsuperscript{277} Originally the disallowance was thought to apply only to benefits accruing to the acquiring corporation.\textsuperscript{278} Later the Fourth Circuit rejected this distinction in Commissioner \textit{v. Costal Oil Storage Co.}\textsuperscript{279} holding the disallowance applicable to the acquired as well as the acquiring corporation. In \textit{James Realty Co. v. United States}\textsuperscript{280} the application of

\textsuperscript{274} Rev. Rul. 73-188, 1973 INT. REV. BULL. No. 17, at 8.
\textsuperscript{275} INT. REV. CODE OF 1954, § 164(c).
\textsuperscript{276} (c) Deduction Denied in Case of Certain Taxes.—No deduction shall be allowed for the following taxes:
\begin{itemize}
\item (1) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.
\end{itemize}
\textsuperscript{277} Treas. Reg. § 1.164-4(b) (1).
\textsuperscript{278} (b) (1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.
\textsuperscript{279} BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 16.21 (3d ed. 1971).
\textsuperscript{280} Alprose Watch Corp., 11 T.C. 240 (1948).
\textsuperscript{278} Costal Oil Storage Co. \textit{v. Comm'r}, 242 F.2d 396 (4th Cir. 1957).
\textsuperscript{280} James Realty Co. \textit{v. United States}, 280 F.2d 394 (8th Cir. 1960).
Section 269 was extended to newly formed corporations which were attempting to benefit from the corporate multiple sur-tax exemption.

The problem next arose as to whether or not Section 269 applies to post-acquisition losses and decreases in asset value. The deduction of post-acquisition losses was disallowed in three of the five circuits that considered the issue prior to 1973. During 1973 the Fifth Circuit, in *Hall Paving Co. v. United States*, joined the majority when they concurred with the analysis of the Second Circuit. The Second Circuit looked to the legislative intent of Section 269 and determined the application of Section 269 was not limited to the disallowance of losses occurring prior to acquisition.

7.02 Redemption of Preferred Stock. The Supreme Court, in *Albers v. Commissioner*, declined to rehear the issue presented by *United States v. Davis* in 1970 involving preferred stock redemptions and the dividend-equivalence test of Section 302(b)(1).

The A&S Transportation Company found it necessary to obtain a loan guaranteed by the Federal Maritime Commission to replace a barge. However, before the Commission would approve the loan, the taxpayers were required to invest $150,000 additional equity in the corporation. The investment was made in the form of preferred stock which was later redeemed by the corporation following repayment of the loan. Although the taxpayers received a return of the same amount they had originally invested, the Commissioner treated the redemption as a dividend, thereby giving rise to ordinary income to each shareholder, when all he received was a return of capital. The Commissioner argued the shareholders did not meet the “not essentially equivalent to a dividend” test of Section 302(b)(1).

The Supreme Court, in *Davis*, interpreted the section to mean a stock redemption will always result in dividend treatment when there is no change in the relative economic interests of the shareholders.

Justices Powell, Douglas and Black dissented from the majority's refusal to rehear the issue stating the interpretation was not justified “by the language of the Code nor by the legislative history, and certainly not by precedent prior to *Davis*.” The dissenters also believed the

281 Borge v. Comm'r, 405 F.2d 673 (2d Cir. 1968); Luke v. Comm'r, 351 F.2d 568 (7th Cir. 1965); R. P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962). The deduction was allowed in the following two circuits. Herculite Protective Fabrics Corp. v. Comm'r, 387 F.2d 475 (3d Cir. 1968); Zanesville Invest. Co. v. Comm'r, 335 F.2d 207 (6th Cir. 1964).

282 *Hall Paving Co. v. United States*, 471 F.2d 261 (5th Cir. 1973).


286 94 S. Ct. at 281.
business reason for the investment and the absence of tax evasion or even avoidance should be taken into consideration.

7.03 Redemptions—Related Corporations. The IRS announced in Revenue Ruling 73-2\textsuperscript{287} it will not follow the decision of the Sixth Circuit in Commissioner v. Stickney,\textsuperscript{288} which held that Section 351 controlled when a transaction was covered by both Sections 304 and 351. The complex problem can be best presented by using the government's illustration from the Revenue Ruling:

Corporation X and corporation Y have been engaged in business for many years and have only voting common stock outstanding. A, an individual, owned all of the outstanding Y stock. The Y stock in the hands of A was a capital asset, within the meaning of section 1221 of the Code. Of the 50 shares of X common stock that were outstanding, A owned 30 shares (60 percent of the outstanding stock) and unrelated individuals owned 20 shares.

Pursuant to a plan, X, for good business reasons, acquired all of the Y stock owned by A in exchange for sufficient X stock so that after the transaction A owned approximately 81 percent of the outstanding X stock. In addition, A received 65x dollars in cash. A realized a gain of 40x dollars as a result of the transaction. The remaining 19 percent of X stock was owned by individuals unrelated to A. At the time of the transaction X had earnings and profits of 80x dollars.\textsuperscript{289}

Section 304 applies when a shareholder sells stock of one corporation to another related corporation if the shareholder owns at least 50 percent of the combined voting power (voting shares or value of shares) of each corporate entity. Section 304 treats the above transaction as a contribution of the value of Y stock to X's capital followed by a redemption of A's stock in X corporation, whereby the status of the redemption is determined by Section 302. The redemption is considered as a dividend (ordinary income) to the recipient unless it meets one of the three tests of Section 302(b): (1) not essentially equivalent to a dividend, (2) substantially disproportionate, or (3) complete termination of the shareholders' interest.

Since the redemption will not qualify under the safe harbors of Section 302(b), it will be treated as a dividend. However, A now owns over 80 percent of the stock of X corporation. Therefore, A qualifies for protection under Section 351(a), which provides for nonrecognition of gain or loss if one or more persons transfer property to a corporation solely for stock or securities and immediately thereafter own 80 percent

\textsuperscript{287} Rev. Rul. 73-2, 1973 INT. REV. BULL. NO. 1, at 13.

\textsuperscript{288} Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).

\textsuperscript{289} Rev. Rul. 73-2, 1973 INT. REV. BULL. NO. 1, at 13.
of the combined voting power of all classes of stock and at least 80 percent of the total number of shares.

The government argued in Stickney and in this Revenue Ruling that Congress intended to require all stock sales between related corporations to run the gauntlet of Section 302. The effect is to permit shareholders owning over 80 percent to receive capital gains treatment while those owning between 50 and 80 percent receive a dividend.

While we can certainly agree that Congress probably intended to prevent capital gains treatment for shareholders owning over 80 percent, it is unfortunate they did not more specifically enact this intent. With the overlap of Sections 304 and 351, it is submitted that the remedy lies with legislative enactment, not with the Commissioner picking up the pen and so decreeing.

7.04 Liquidation—Involuntary Conversion. Section 337 provides for nonrecognition of gain or loss at the corporate level when corporate assets are sold or exchanged subsequent to the adoption of a plan of liquidation and all assets are distributed to shareholders within twelve months following the date of adoption. Section 337 was adopted in 1954 to eliminate the confusion created by Commissioner v. Court Holding Co.\(^{290}\) and United States v. Cumberland Public Service Co.\(^{291}\) in determining whether the assets were sold by the corporation or by the shareholders subsequent to a liquidation. In Revenue Ruling 56-372\(^{292}\) the Treasury refused to treat an involuntary conversion as a sale or exchange, thereby precluding the application of Section 337. After defeats in Kent Mfg. Corp. v. Commissioner\(^{293}\) and Towanda Textiles, Inc. v. United States,\(^{294}\) the Treasury changed its policy in Revenue Ruling 64-100.\(^{295}\) As a result an involuntary conversion is now considered a sale or exchange under Section 337.

If corporate property is destroyed by fire or other casualty loss, when does the sale occur? The Eighth Circuit in United States v. Morton\(^{296}\) holds the sale does not occur until the insurance proceeds are received, or are readily determinable, thereby permitting the corporation to adopt a plan of liquidation subsequent to the casualty loss and to avoid federal tax at the corporate level. During 1973 the Sixth Circuit in Central Tablet Mfg. Co. v. United States\(^{297}\) determined the sale occurs on the date of the

\(^{290}\) Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
\(^{293}\) Kent Mfg. Corp. v. Comm'r, 288 F.2d 812 (4th Cir. 1961).
\(^{296}\) United States v. Morton, 387 F.2d 441 (8th Cir. 1968).
\(^{297}\) Central Tablet Mfg. Co. v. United States, 481 F.2d 954 (6th Cir. 1973); United States v. Morton 387 F.2d 441, 448 (8th Cir. 1968).
fire, thereby precluding the benefits of Section 337 if the plan of liquidation was not adopted before the fire. The Eighth Circuit in *Morton* reasoned that a sale or exchange does not occur when tangible assets are converted into a chose in action since collection is dependent upon compliance with conditions of the policy, proof of loss and investigation by the insurance company. The court held: "[I]t would thus appear that the sale or exchange by involuntary conversion is not completed until either the policy proceeds are received, or an enforceable settlement of a determined amount is agreed upon or a court judgment obtained."\(^{298}\) The government pointed out that in federal condemnation cases the date of sale is the date when the proceedings are filed and the funds deposited. State law varies as to date when title passes in condemnation proceedings. The Eighth Circuit distinguished the condemnation analogy by pointing out that the title passed and an enforceable right to a specific award accrued at the date of filing. Furthermore, condemnation proceedings are normally preceded by negotiations giving the taxpayer time to adopt a plan of liquidation.

The Sixth Circuit in *Central Tablet Mfg. Co.* noted that while *Towanda* and *Kent* had expanded Section 337 to include involuntary conversions, Congress never evidenced an intent to provide a windfall for taxpayers experiencing an involuntary conversion prior to the adoption of a plan of liquidation. Congress has provided for nonrecognition of insurance proceeds through Section 1033, for taxpayers suffering an involuntary conversion who choose to rebuild.

During 1973 a district court, in California,\(^{299}\) followed the Eighth Circuit and held the sale or exchange did not occur at the time of the fire.

It is the author's opinion that the reasoning of the Sixth Circuit coupled with the analogy to condemnation proceedings presents the better view of when a sale or exchange occurs. This is an issue which will undoubtedly be resolved by the Supreme Court.

**7.05 Distribution of Appreciated Assets.** A major tax problem was presented to *Peeler Realty Co., Inc.*\(^{300}\) when it became necessary, because of the heavy ad valorem taxes annually assessed, to divest itself of extensive holdings of appreciated forest lands. The land had a tax basis of approximately $40,000 and a fair market value of $2,500,000. The problem was complicated by the fact that the founder of the corporation had designated the family corporation as the principal beneficiary of his estate and the founder had become mentally incompetent to change his

\(^{298}\) 387 F.2d at 448.
\(^{300}\) *Peeler Realty Co., Inc.*, 60 T.C. No. 74 (August 14, 1973).
will. The founder's condition precluded liquidation and dissolution of
the corporation, a method approved of by the Treasury. 301

The corporation had been approached by several paper mills in
the past but had rejected all the offers. A sale of the land by the
corporation and subsequent distribution to the shareholders would result
in a double taxation. The corporation would be taxed at capital gains
rates on the sale of the land and the stockholders would be charged
with receiving an ordinary dividend.

The shareholders of the corporation approved a distribution of the
lands to the shareholders as an ordinary dividend. After the distribution
the shareholders authorized an agent to negotiate a sale of the lands. Bids
were taken and the land was eventually purchased by one of the paper
mills that had originally been approached by Peeler Realty. The
corporation did not report the sale on the corporate income tax returns.
Each stockholder reported his pro rata share as capital gains. 302 The
corporation had no earnings or profits from which to pay a dividend
so that any distribution in excess of basis would be taxed as a return of
capital at capital gains' rates. 303 The Commissioner contended that the
sale should be imputed to the corporation and proceeds taxed as an
ordinary dividend to the shareholders.

Corporate distributions of appreciated property under the circum-
stances set forth are not taxable to the corporation unless the sale can be
imputed to the corporation or the transaction can be viewed as an
anticipatory assignment of income. Under the first exception, the sale
is imputed to the corporation on the theory that it is the corporation
which in substance, though not in form, sells the property. 304 An imputed
sale generally arises where the corporation has negotiated the sale of
a corporate asset with a buyer. The corporation then either liquidates
or distributes the assets as a dividend, whereupon the shareholders
complete the sale with the buyer.

The incidence of taxation depends upon the substance of a
transaction. The tax consequences which arise from gains from
a sale of property are not finally to be determined solely by the
means employed to transfer legal title. Rather, the transaction is to
be viewed as a whole . . . A sale by one person cannot be transformed

301 INT. REV. CODE OF 1954, §§ 331-337.
302 Hines v. United States, 477 F.2d 1063, 1067 (5th Cir. 1973). Hines was one of
the stockholders of Peeler Realty Co., Inc. The Hines case was appealed to the Fifth
Circuit where decision was for the taxpayer. The facts and the outcome of both
cases, Peeler & Hines, are identical and are based on the same legal precepts. The
cases will be considered together and cited interchangeably as comment requires.
303 INT. REV. CODE OF 1954, §§ 301(c), 316(a).
304 Commissioner v. Court Holding Co., 324 U.S. 331 (1945); United States v.
Lynch, 192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952); A.B.C.D.
for tax purposes into a sale by another by using the latter as a conduit through which to pass title.\textsuperscript{305}

However, where the corporation never planned to make the sale itself, liquidated its holdings and its shareholders subsequently sold the assets to a party originally approached by the corporation, the sale was not imputed to the corporation.\textsuperscript{306}

Section 337 eliminated the imputed sale problem for the liquidating corporation. If the corporation distributes all of its assets and liquidates within one year of the adoption of the plan no gain or loss will be recognized to the corporation on a subsequent sale of the assets by the shareholders. The problem still exists for those corporations that do not in fact liquidated under Section 337. In \textit{A.B.C.D. Lands, Inc.}\textsuperscript{307} an in-kind distribution of grain acquired by the corporation as rental on its holdings of farm land, subsequently sold by the distributees, was imputed to the corporation. Normally, no gain or loss would be recognized on the distribution of corporate property under Section 311, but in \textit{A.B.C.D. Lands, Inc.} the corporation actively participated in the negotiation and sale of the grain. And in fact, the shareholders could not have resold the grain but for their relationship with the corporation.\textsuperscript{308} This was a primary reason why the sale was imputed to the corporation.

The lack of corporate involvement in the sale of the forest lands in \textit{Hines v. United States} was a determinate factor in the court’s decision.

We hold that the sine qua non of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed. Only if the corporation in fact participated in the sale transaction; by negotiation, prior agreement, post-distribution activities, or participated in any other significant manner, could the corporation be charged with earning the income sought to be taxed.\textsuperscript{309}

This decision is supported by dicta in a First Circuit decision that the sale will be imputed to a non-liquidating corporation unless “the sale was the result of independent and active negotiations by its stockholders....”\textsuperscript{310}

The imputed income theory focuses on the role of the corporation in the creation of the income. The doctrine of anticipatory assignment of income, however, is primarily concerned with the type of assets that is distributed to the shareholders. The owner of rights to income or potential income cannot avoid having such income recognized by transferring the

\begin{footnotes}
\item[305] Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).
\item[308] Id. at 849, 850.
\item[309] Hines v. United States, 477 F.2d 1063, 1069 (5th Cir. 1973).
\item[310] Waltham Netoco Theatres, Inc. v. Comm’r, 401 F.2d 333, 335 (1st Cir. 1968).
\end{footnotes}
rights prior to the time at which they must be recognized. The Commissioner asserted that distribution of lands by Peeler Realty constituted such an assignment of income. The doctrine has been held not to apply to a transfer of appreciated assets, the appreciated value of which can only be realized by a sale. In *Cambell v. Prothro* the taxpayer made a gift of 100 head of calves to a charity then negotiated the sale of the calves with the remainder of his herd. The Commissioner was unsuccessful in his attempt to apply the doctrine of anticipatory assignment of income. The court found in reaching a similar result in *Peeler Realty Co., Inc.*, that:

Cases which have found an anticipatory assignment of income are clearly distinguishable from the one before us. In those cases, there was no necessity for a sale, or for any other significant effort by the transferee. Here, as noted above, the shareholders had to effect a sale before the unrealized appreciation in the lands could become income.

In the cases where the doctrine has been applied the recipient of the income has usually been inactive, engaging in no substantial income-producing activities.

After rejecting the application of the doctrine of anticipatory assignment of income and imputation of sale, the Fifth Circuit limited its finding somewhat to the particular facts of the case. The court pointed out that Peeler Realty Co., Inc. had substantially liquidated its holdings retaining only passive income-producing property in the form of low-rental housing, and probably would have completely liquidated had it not been for the unfortunate terms of the corporate founder’s will. The court recognized the loophole in Section 301 that allows deficit corporations to distribute appreciated property without having the distribution taxed as a dividend, but concluded:

[W]e do not think it is proper to attempt to plug that loophole by conjuring up visions of corporate sales where no corporate activities justify such images... the aperture exists because distributions of appreciated property by a deficit corporation are not deemed distributions in the nature of dividends.

It does not appear as though the Court will be willing to venture far from the facts of this case.

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312 *Cambell v. Prothro*, 209 F.2d 331, 336 (5th Cir. 1954). See also Commissioner v. First State Bank, 168 F.2d 1004 (5th Cir. 1948); Humacid Co., 42 T.C. 894 (1964); Stuart A. Rogers, 38 T.C. 785 (1962).
313 *Peeler Realty Co., Inc.*, 60 T.C. No. 74 (August 14, 1973).
314 Helvering v. Horst, 311 U.S. 112 (1940); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961); Doyle v. Comm’r, 147 F.2d 769 (4th Cir. 1945).
315 477 F.2d at 1071.
Hines has been cited once since its decision to support a finding that a sale made by a separate corporate entity should not be imputed to the related corporation that originally transferred the property to the seller. R & T Developers was engaged in land development, one of its subdivisions contained two lots that would be especially profitable when sold. B & C Corporation was created as a Subchapter S corporation to negotiate the sale of the two lots, title remaining in R & T Developers. B & C Corporation applied for and received in its own name a needed zoning variance and negotiated the sale of the lots to two oil companies. After negotiations were completed R & T Developers deeded the land to B & C Corporation at cost, $6,500, the lots having a fair market value of $35,000 each. B & C Corporation reported the sales on its own tax return. The Commissioner asserted the sale of the property should be imputed to R & T Developers. The Tax Court found on the facts that the transactions more nearly resembled those found in the United States v. Cumberland Public Service Co. than those of Commissioner v. Court Holding Co. and held that the actions of B & C Corporation were sufficiently independent of control by R & T Developers to be regarded as a separate transaction.

7.06 Incorporation of Cash-Basis Taxpayer. Cash-basis taxpayers, who intended to incorporate their businesses, won a substantial victory when the Second Circuit reversed the Tax Court's interpretation of Section 357(c) in John P. Bongiovanni. The Second Circuit held:

[T]he word "liability" is used in Section 357(c) in the same sense as the word "liability" referred to in the legislative history of Section 357(c). It was not meant to be synonymous with the strictly accounting liabilities involved in the case at bar. Section 357(c) was meant to apply to what might be called "tax" liabilities, i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction.

In a decision to which five judges dissented, including Judge Quealy who wrote the Tax Court opinion in Bongiovanni, the Tax Court in Wilford E. Thatcher found the Second Circuit's interpretation of Section 357(c) to be too narrow and refused to follow the Second Circuit's decision.

Section 351(a) provides that where property is transferred to a corporation solely in exchange for stock or securities of such corporation

and immediately thereafter the transferor is in control of the corporation, no gain or loss shall be recognized in the exchange. However, Section 357(c)(1) provides that in a Section 351 exchange:

[If the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.]

To the cash-basis taxpayer the adjusted bases of accounts receivable is zero because he has not reported them as income even though the market value of the receivables might be a considerable proportion of the taxpayer’s assets. All liabilities, including accounts payable, transferred to the corporation are transferred at their book value, even though the taxpayer would not be allowed a deduction for the payables until he had actually paid them. The Tax Court applies unequal treatment to the two categories even though the accounts payable, in most instances, will correspond to the outstanding accounts receivable.

For purposes of determining gain on the transfers the Commissioner includes all liabilities, including trade accounts payable, and affixes an adjusted basis of zero to all trade accounts receivable and other assets which have an adjusted basis of zero to the cash-basis taxpayer. The liabilities assumed in excess of the assets transferred under this interpretation result in the recognition of substantial gain in an otherwise non-recognition transfer under Section 351.

Several arguments are presented in the various cases on point to overcome the Tax Court’s interpretation of the section. In Peter Raich, the case cited as controlling in following cases, the taxpayer contended:

[T]hat Congress intended Section 357(c) to apply to a Section 351 exchange only if the liabilities assumed by the corporate transferee exceed, not only the “adjusted basis of the property transferred,” but also the book value of that property. [and] ... [I]n the alternative ... (if 357(c) does apply) the trade accounts receivable had as basis, ..., at least equal to the amount of the trade accounts payable. ...

The taxpayer asserted that Section 357(c) should apply only where

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320 INT. REV. CODE OF 1954, § 357(c) (1).
321 Treas. Reg. § 1446-1(c)(1)(i). Expenditures are to be deducted for the taxable year in which actually made.
322 Peter Raich, 46 T.C. 604 (1966).
323 Id. at 607.
the transferor derived some economic gain from the transfer.  

The Tax Court held that a literal interpretation of Sections 351(e)(1) and 357(c) compelled application of Section 357(c) to the transaction and that if Congress desired to limit the applications of the section to those situations where an economic benefit results, they would have employed the necessary language.

The fact that the receivables had a book value... at the time of the transfer is irrelevant to the disposition of this issue since the pertinent language of Section 357(c) speaks only in terms of the "adjusted basis" of the property transferred.

In applying Section 357(c) to the facts herein, we are not unmindful that the result reached may conflict with the well-established interest of Congress to foster tax-free business reorganizations.

Even though the Tax Court realized its decision would seriously affect the tax-free incorporation of cash-basis taxpayers it believed the solution to the problem to be legislative and not judicial.

The majority of the Tax Court's opinion in John P. Bongiovanni is directed to the attempt by the taxpayer to avoid the result of Raich by switching to an accrual method of accounting prior to the incorporation. The taxpayer lost for failure to receive the Commissioner's approval of the change in accounting methods. The Tax Court cited Peter Raich as controlling.

On appeal the Second Circuit decided the Tax Court had erred in its interpretation of Section 357(c) when applied to a tax-free Section 351 transfer of assets by a cash-basis taxpayer to his controlled corporation. The Second Circuit rejected a literal interpretation of Section 357(c) and adopted a construction that discounted trade accounts payable as a "liability," finding that payables of a cash-basis taxpayer are "liabilities" for accounting purposes but not for tax purposes under Section 357(c). Recognizing that the problem does not arise in the case of an accrual-basis taxpayer, the court found no justification for making the method of accounting chosen become determinative of the tax benefits where the purpose of the section is to encourage tax-free business reorganizations. This interpretation is in accord with the express purpose of the 1954 Internal Revenue Code. As stated in the House report Sections 351 to 373 were, "designed to insure that the same tax consequences result from the different types of transactions which are available to accomplish

324 Testor v. Comm'r, 327 F.2d 788 (7th Cir. 1964). Where the taxpayer was economically benefitted by the corporate assumption of the liabilities. The examples set forth in the Treasury Regulations are ones in which the taxpayer realizes an economic benefit from the transfer. Treas. Reg. § 1.357-2(2).
325 Peter Raich, 46 T.C. 604, 611 (1966).
substantially the same result." While the court's decision does provide an equitable result, it strains the section beyond what it was intended to encompass. However, since Section 357(c) specifically provides that assets be valued at their "adjusted basis" the only method of circumventing the problem as viewed by the court was to develop a "tax" definition of liabilities.

The Tax Court has refused to follow the definition of "liabilities" expressed in Bongiovanni, and, in Wilford E. Thatcher confirmed its holding in Peter Raich. Thatcher presented arguments similar to those presented by the taxpayers in Bongiovanni and Raich and an additional argument based on his partnership status. Section 751(a) provides that in the sale or exchange of partnership assets unrealized receivables of the partnership are valued at market value for purposes of determining amount of gain or loss on the transaction. Thatcher contended that receivables should be valued at market for the purposes of a Section 351 reorganization. The Tax Court emphasized that Section 751 was designed to measure income and not the tax consequences of a transaction subject to Section 351 and rejected the contention.

The court realized the inequities involved and pointed out that had the taxpayer been on the accrual method of accounting the problem would not have arisen. The court further noted that the tax consequences could have been avoided by withholding the payables and a similar amount of receivables from the reorganization. In confirming the holding in the Raich case the court again commented that the changes required were administrative or legislative and not judicial.

The most reasoned and equitable interpretation of Section 351(c) appears in the dissenting opinion by Judge Hall in Thatcher. He points out that if the cash-basis taxpayer transfers payables and an equal amount of receivables outside of Section 351 there would be no gain realized on the transaction; however, under the majority's opinion a taxpayer making a similar exchange with his controlled corporation would have taxable income equal to the payables transferred. Section 357(c)(1) provides that the gain shall be treated as a gain from the sale or exchange of property. The taxpayer should be considered to have made a taxable "sale" of his receivables for the assumption and payment of his payables by the corporation. When a cash-method taxpayer sells his receivables for assumption and payment of his payables, he is as much entitled to a deduction for payment of the payables as he is accountable for income on the sale of the receivables.

Nothing in Sections 351 or 357 requires treatment of only one side of the receivable-payable "sale" as a recognizing transaction. The

statutory purpose is far better served if payables paid by the transferee in the taxable year of transfer are treated as deductible to the transferor to the extent the offsetting receivables are treated as received by him. 329

This analysis does not create the strain upon Section 357(c) that the interpretation given the word "liabilities" in Bongiovanni created. Where payables represent ordinary and necessary business expenses they should be netted against the trade accounts receivable creating no taxable gain to the extent that receivables offset payables. This interpretation would place the cash-basis taxpayer on an equal footing with the accrual taxpayer and would not be disruptive of the purpose of Section 357(c). Gains recognized on the transfer of encumbered property would still be taxed as would those where the taxpayer created receivables in the nature of a promissory note to offset liabilities330 or where the liabilities assumed exceeded the value of assets transferred.331

The manner in which Section 357(c) is presently being applied by the courts outside of the Second Circuit will continue to trap unwary taxpayers until either Judge Hall's interpretation is adopted (unlikely) or some legislative change occurs (also unlikely). The cash-basis taxpayer who wishes to incorporate and avoid the Section 357(c) trap has two options. First, he can withhold payables and sufficient receivables to cover them from the reorganization. This has the disadvantage of depriving the new corporation of an often needed cash flow at the start of business. The alternative is to switch to the accrual method of accounting prior to reorganization. This may require some planning so that a question of tax avoidance is not created. However, business reorganizations are usually considered for some period prior to actual initiation of the plan providing sufficient time for the changeover.

7.07 Accumulated Earnings. Sections 531 and 532 impose a penalty upon corporations formed or used for the purpose of avoiding the income tax by permitting earnings and profits to accumulate instead of distributing dividends to shareholders. However, a corporation may accumulate earnings to meet reasonable anticipated future needs of the business.332 Inland Terminals, Inc. v. United States333 held that a wholly owned subsidiary could accumulate earnings for the anticipated business needs of its parent.

Is it possible for a corporation to avoid the accumulated earnings tax by redeeming stock, a portion of which is charged to earnings and

329 Id.
331 Testor v. Comm'r, 327 F.2d 788 (7th Cir. 1964).
332 Treas. Reg. § 1.537-1(b)(1).
333 Inland Terminals, Inc. v. United States, 477 F.2d 836 (4th Cir. 1973).
profits under Section 312(e)? In *Ostendorf-Morris v. United States*,334 the court imposed the tax when earnings and profits were reduced by a redemption which did not affect the current year's taxable profit. In a 1973 case, *G.P.D. Inc.*,335 the Tax Court refused to impose the accumulated earnings tax when the corporation redeemed stock previously donated to a charitable organization. For the year in question, taxable income less income taxes and dividends was $211,343. The amount of redemption properly chargeable to earnings and profits was $432,640, thereby causing a net decrease in accumulated earnings. The Tax Court held that a net increase in accumulated earnings is required before the tax will be imposed.

8.00 Subchapter S Corporations

8.01 Second Class of Stock. After the original promulgation of Treasury Regulation 1.1371-1(g)336 the IRS took the position that any obligation that is purported to represent debt but in actuality is found to represent equity will constitute a second class of stock. This position was softened somewhat by the 1966 amendment that recognized that if the debt was held in proportion to the stock held by the shareholders the debt will be considered a contribution to capital rather than a second class of stock.337 The regulation has continued to be under attack since its amendment338 and the Treasury has finally decided to reconsider Section 1.1371-1(g) due to the number of cases that have found the section invalid.339

To attack a corporation's status on the basis of the one class of stock requirement, the Commissioner has been required to show two facts. First, that the "debt" held is in actuality equity and not debt. Second, that the equity interest constitutes a second class of stock. The Commissioner has generally attempted to apply the "thin capitalization" doctrine to show that the debt is actually equity. Thin capitalization is a determinative factor in showing that a corporation has engaged in a tax avoidance scheme by distributing corporate earnings as interest on debt instead of as dividends. Several factors determine thin capitalization: high debt to equity ratio, subordination of the debt to other creditors,

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335 G.P.D. Inc., 60 T.C. No. 53 (June 6, 1973).
336 Treas. Reg. § 1.1371-1(g) (1959).
interest based on profits, no fixed maturity, provisions for repayment or remedies for default.\textsuperscript{340}

In the principal cases\textsuperscript{341} the Commissioner was usually successful in showing that the debt was equity, the courts preferring to consider the "equity" as a further contribution to capital and not a second class of stock.\textsuperscript{342}

We perceive no basis in law for the Commissioner's attempt to inject the "debt versus equity" analysis into the application of the "one class of stock" requirement.\textsuperscript{343} We conclude that the legislative use of the term "stock" foreclosed the Commissioner from granting to or withholding from a taxpayer favorable Subchapter S income tax treatment on the basis of that taxpayer's capital structure (i.e., debt versus equity).\textsuperscript{344}

The finding that the debt versus equity question is not relevant to the single class of stock requirement of a Subchapter S corporation is derived from the purpose of the requirement.

The purpose of the single class of stock requirement was none other than to avoid the administrative complexity in the allocation of income which would result with more than one class of stock when preferred dividends were paid in excess of current earnings from undistributed but taxed prior earnings.\textsuperscript{345}

Section 1371 does not concern itself with the method used to capitalize a small business corporation. The one class of stock requirement was enacted to avoid administrative problems in the distribution of the corporation's income. Where the equity is treated as debt by the Subchapter S corporation the distribution problems do not occur because "interest" on debt is paid with untaxed earnings.

The IRS first amended Section 1.1371-1(g) of the regulations after the Tax Court concluded that debt held in the same proportion as the stock was not a second class of stock.\textsuperscript{346} In all of the cases cited in footnote 338 except Portage Plastics Co., Inc. v. United States the debt was held by the stockholders of the corporation but in disproportionate

\textsuperscript{341} See note 338 supra.
\textsuperscript{343} Shores Realty Co., Inc. v. United States, 468 F.2d 572, 577 (5th Cir. 1972). \textit{But see} Amory Cotton Oil Co. v. United States, 468 F.2d 1046, 1050 (5th Cir. 1972). Where the court accepted the relevance of the debit-equity distinction if a tax avoidance scheme were disclosed, but found no such scheme in \textit{Amory}.
\textsuperscript{345} W. C. Gammon, 46 T.C. 1 (1966).
amounts as compared to their holdings of stock. In each of the cases the court found that the Commissioner had exceeded his power in applying regulation 1.1371-1(g) to terminate the Subchapter S status.

The en banc decision in *Portage Plastics* came as a final blow to the Commissioner's position as to the application of regulation 1.1371-1(g). The holders of the debt instruments in *Portage Plastics* were not stockholders of the corporation. The court held it was unnecessary to determine whether the instruments were debt or equity and that even if they were determined to be equity they should not be considered a second class of stock within the meaning of the statute. "To the extent that Treasury Regulation 1.1371-1(g) calls for a contrary result, it is arbitrary and beyond the power of the Commissioner."346

The Treasury has promulgated Technical Information Release 1248347 proposing amendments to regulation 1.1371-1(g). Pending revision of the regulation the Service will not litigate the issue of whether obligations which are purported to be debt but are actually equity qualify as a second class of stock so as to terminate the Subchapter S status.

The position the Service will take in the revision of the regulation is an open question. The unified position of the courts appears to be that the debt-equity dichotomy only arises in a tax avoidance situation and not in the situation under attack—the status of a corporation's Subchapter S election. The purpose of the "one class of stock" requirement has generally been found to be the avoidance of administrative problems in the distribution of the electing corporation's dividends. As long as no administrative problems are created by the issuance of "debt" the termination of the corporation's Subchapter S status appears to be unnecessary.

8.02.1 Passive Investment Income. The Tax Court has refused to follow the termination made by the Fifth Circuit in vacating a Tax Court decision, *House v. Commissioner*,348 as to the meaning of passive investment income. In *Jasper L. House, Jr.*,349 the Tax Court applied

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Pending revision of the regulation, the IRS will not litigate the issue of whether Subchapter S obligations which purport to represent debt, but which actually represent equity capital, constitute a second class of stock in cases factually similar to Amory Cotton Oil Co. v. United States, 468 F.2d 1046 (5th Cir. 1972); Shores Realty Co., Inc. v. United States, 468 F.2d 572 (5th Cir. 1972); Portage Plastics Co., Inc. v. United States, ___ F.2d ___ (7th Cir. 1973); and James L. Stinnett, 54 T.C. 221 (1970).
a mechanical-literal reading of Section 1372(e)(5)\textsuperscript{350} in holding a corporation’s election under Subchapter S is terminated if more than 20 percent of its gross receipts are derived from interest. House contended that small loan companies are excluded from the application of Section 1372(e)(5) because (1) such companies are actively engaged in the collection of passive income (interest) and (2) such companies are not personal holding companies under Section 542. Therefore, they do not generate personal holding company income as Section 1372(e)\textsuperscript{351} was originally entitled. House made the further arguments that repayments of loans should be included in gross receipts and that, in accordance with a district court’s determination in \textit{Valley Loan Association v. United States},\textsuperscript{352} Treasury Regulation 1.1372-4\textsuperscript{353} should be held invalid.

In upholding the taxpayer’s contentions the circuit court differentiated between “passive” and “active” passive investment income. The word interest should be construed in conjunction with the heading of the section “personal holding company income” or “passive investment income” under the 1966 Act which modified the language.

We are of the view that the words “personal holding company income” and “passive investment income” were deliberately employed by Congress to make clear its legislative purpose. The word “interest” cannot be read in isolation. To effect termination of subchapter S status the interest must be part of “personal holding company income.” It was not such; neither did the interest earned by a small loan company fit the words “passive investment income.”\textsuperscript{354}

The Tax Court, in two cases presented thus far, \textit{T. J. Marshall}\textsuperscript{355} and \textit{Joseph B. Zychinski},\textsuperscript{356} has declined to follow the holdings in \textit{House} and \textit{Valley Loan}.

In \textit{I. J. Marshall} petitioner relied on the holding in \textit{Valley Loan} that Treasury Regulation 1.1372-4 is invalid insofar as it excludes from gross receipts the repayment of loans made in the regular course of business. Marshall and Miller, the owners of Realty Investment Company of Roswell, Inc. (Realty), were disallowed deductions for the undistributed

\textsuperscript{350} \textit{INT. REV. CODE OF 1954}, § 1372(e)(5)(A) Passive Investment Income. “[A]n election under subsection (a) made by a small business corporation shall terminate if, for any taxable year . . . such corporation has gross receipts more than 20 percent of which is passive investment income.”

\textsuperscript{351} \textit{INT. REV. CODE OF 1954}, § 1372(e)(5) (1958), \textit{as amended}, 28 U.S.C. 1372(e)(5) (1966). Personal holding company income. “[I]f . . . such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities . . . .”

\textsuperscript{352} \textit{Valley Loan Ass'n v. United States}, 258 F. Supp. 673 (D. Colo. 1966).

\textsuperscript{353} \textit{Treas. Reg. § 1.1372-4(b)(5)(iii)(e)(iv) Gross Receipts. “[G]ross receipts does not include . . . amounts received as a repayment of a loan. . . .”

\textsuperscript{354} \textit{House v. Comm'r}, 453 F.2d 982, 987 (5th Cir. 1972).

\textsuperscript{355} \textit{I. J. Marshall}, 60 T.C. No. 29 (May 21, 1973).

\textsuperscript{356} \textit{Joseph B. Zychinski}, 60 T.C. No. 100 (Sept. 20, 1973).
net operating losses of Realty, under a determination by the Commissioner that Realty was not eligible to report its income as a tax option corporation under the provisions of Section 1372(2). Realty was licensed as a small loan company and derived approximately 45 percent of its income from interest payments. Petitioners argued that if loan repayments were included in gross receipts the percentage of passive income would be less than 20 percent and Realty would qualify under Section 1372. This interpretation was approved in Valley Loan:

There is nothing in subchapter S which specifically excludes from gross receipts the amount received for repayment of such loans. . . . the act itself indicates that congress intended Section 1372(e)(5) to apply only to personal holding company income... Loan companies engaging in activities similar to those of plaintiff have been excluded by congress from the definition of a personal holding company.

[T]reasury Regulation 1.1372-4 insofar as the defendant construes it to exclude from gross receipts the repayment of the loans made and installment contracts acquired by the plaintiff in the ordinary course of its loan business is contrary to the congressional act and congressional intent as evidenced by the act and is therefore invalid as applied to the plaintiff’s operation.357

The Tax Court in deciding against the taxpayer on the make-up of gross receipts cites two cases as controlling, Buhler Mortgage Co.358 and Alfred M. Sieh.359 The taxpayer in Buhler Mortgage Co. was engaged in purchasing deeds of trust and discounting them with various banks. The court held that the transactions whereby the taxpayer negotiated the notes were equivalent to a sale of securities and under 1372(e)(5) constituted “personal holding company income” notwithstanding the fact that gain on the sale of securities by security dealers was excluded by Section 543(e)(2) from personal holding company income.

In the second case cited, Alfred M. Sieh, the Tax Court held, “Only the actual amounts of principal payments received during the year are includable [in gross receipts] if the cash method is employed.”360 The company in Sieh provided financing to prospective purchasers who could not otherwise finance the purchase of a home. By refinancing the property to the homeowner at a higher rate of interest, the company was basically making loans much as Realty did in J. Marshall. How Sieh supports the court’s holding that repayments on loans are not includable in gross receipts escapes this writer.

Marshall presented the alternative argument that Realty’s interest

357 258 F. Supp. at 675.
360 56 T.C. at 1387.
income should not be considered "passive investment income" under 1372(e)(5). Petitioner basing his argument on the previously discussed House v. Commissioner, the Tax Court declined to follow the holding of the Fifth Circuit, preferring to uphold the Tax Court decision in Buhler Mortgage Co.

We therefore respectfully decline to follow the Appeals Court's holding in the House case and conclude that interest and rental income are part of "passive investment income" even though the recipient of such interest or rental income may be actively engaged in a small loan or real estate business.361

The second case in which House was raised as a defense to the disallowance of losses incurred by a Subchapter S corporation is Joseph B. Zychinski.362 The corporation in which Zychinski was a shareholder, Richter & Co., engaged in the trading of stocks and securities for its own account and acted as a broker in over-the-counter securities for others. Zychinski presented to the Tax Court the same arguments asserted in Marshall and House as to the meaning of "passive investment income." As expected, the court affirmed its own findings in Buhler Mortgage Co. Petitioner also argued that the reference to "sales or exchanges of stock or securities" does not apply to the gross receipts from the sale of inventory but only to the sale of capital assets. In deciding against petitioner the court stated: "The basic problem with petitioner's argument is that the language of Section 1372(e)(5) nowhere limits 'sales or exchanges of stock or securities' to capital assets, nor does it differentiate between trade or business activity and nonbusiness activity."363

The Tax Court accepts a literal application of Section 1372. The statute makes no distinction between "passive" versus "active" interest or the method (activity) employed to generate the corporation's income. In the court's view whether or not the interest received by loan companies is considered active or passive it is still interest and specifically included in the definition of passive investment income contained in Section 1372. This interpretation by the Tax Court precludes the possibility of a small loan company qualifying for the Subchapter S tax option. If the problem that occurred in Marshall should arise again the petitioner would do well to take his case to District Court for a determination and avoid the Tax Court if at all possible.

8.02.2 Oil Lease Bonuses v. Royalty. The payment of a "bonus" upon the execution of an oil and gas lease does not constitute "personal holding company income." In Swank & Son, Inc.364 the Commissioner

362 Joseph B. Zychinski, 60 T.C. No. 100 (Sept. 20, 1973).
363 Id.
determined that a bonus payment upon the execution of an oil and gas lease was personal holding company income under 1372(c)(5) and terminated plaintiff's Subchapter S election. This holding is in accordance with Commissioner v. Clarion Oil Co.\textsuperscript{365} wherein the Court of Appeals for the District of Columbia held, "[T]he word 'bonus,' as used in oil lease parlance is, in relation to federal taxation, included in the word 'royalty.'" This holding was followed by the Fifth Circuit in Bayon Verret Land Co. v. Commissioner.\textsuperscript{366}

The District Court in Swank arrived at a different conclusion: "the terms 'bonus' and 'royalty' had definite meanings in the oil and gas industry—the words did not mean the same thing."\textsuperscript{367} As to whether Congress failed to include the word "bonus" as personal holding company income because it believed it to be included in the word "royalty" or that it intended bonus should not be included at all, the court stated:

As between the proposition that a Congress knowledgeable about oil and gas terminology stretched the meaning of the word "royalty" to include "bonus" and the proposition that the word "bonus" did not appear because it was not the purpose to treat as bonus or personal holding company income, I would choose the latter.\textsuperscript{368}

The holding in Swank is in disagreement with analogous holdings of the Supreme Court that as to depletion deductions a bonus will be considered as an advance royalty.\textsuperscript{369} The court in Swank looked to state decisions and industry meanings to determine whether "bonus" was included in "royalty." In construing the tax laws the usually accepted meanings of words or the words in state decisions are not controlling in those instances where to follow such meaning would impair the uniformity of the federal tax laws. In view of the decisions in other circuits and the implications arising from analogous Supreme Court decisions the District Court for Montana may have erred in the exclusion of "bonus" payments from personal holding company income.

The Montana Court does make one interesting comment that goes to the whole subject of passive income. The bargaining for oil and gas leases is an integral part of land management and must be actively pursued. The court differentiates between "bonus" and "royalty" on the basis that a "bonus" is \textit{active} and a "royalty" is \textit{passive} income. The court defines passive income as that which "comes to the owner of the right without the expenditure of effort or the exercise of judgment on the part of the

\textsuperscript{365} Commissioner v. Clarion Oil Co., 148 F.2d 671 (D.C. Cir. 1945), cert. denied, 325 U.S. 881 (1945).
\textsuperscript{366} Bayon Verret Land Co. v. Comm'r, 450 F.2d 850, 854 (5th Cir. 1971).
\textsuperscript{367} 362 F. Supp. at 897.
\textsuperscript{368} Id. at 900.
\textsuperscript{369} Anderson v. Helvering, 310 U.S. 404 (1940); Palmas v. Bender, 287 U.S. 551 (1933); Burnet v. Harmel, 287 U.S. 103 (1932).
owner...." If this definition can be given weight it would apply to the small loan business or the active trading of securities both of which require a considerable expenditure of both effort and judgment on the part of the owner.

8.03 Creation of Basis to Absorb Loss. The income of an electing small business corporation is taxable to the shareholders of the corporation in proportion to their pro rata share of the corporate stock. The income of the corporation may be offset by the net operating losses of the corporation to the extent of the adjusted basis of the shareholder's investment. The adjusted basis of the shareholder's investment includes the adjusted basis of the stock of the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder. The shareholder's basis in stock may be increased by the amount of any undistributed dividends taxable to the shareholder or decreased by an amount equal to the shareholder's portion of any net operating losses for any taxable year attributed to such stock. The basis of any indebtedness will also be reduced by the losses, but only to the extent that such amount exceeds the shareholder's basis in the stock of the corporation. To the extent that the corporation's losses exceed the basis of the shareholder's investment they are not deductible in future years and are lost.

The question arises whether the stockholder can, in a year of heavy losses, increase the adjusted basis of his investment to absorb the loss passed by purchasing additional stock for promissory notes. This method was attempted in Silverstein v. United States. Silverstein's Subchapter S corporation's stock showed a basis of $1,000, the corporation's net operating losses for the year would greatly exceed this amount. Three days before the end of the taxable year the stockholders purchased for promissory notes an additional $200,000 worth of stock. The Commissioner considered the transaction a sham and the district court agreed.

There was no "actual economic outlay" involved in the transaction. In the ensuing six years only one interest payment was made and no payments on the principal. The only other indebtedness of the corporation was already personally indorsed by Silverstein so that the additional liability created by the notes had no economic substance. One of the

370 362 F. Supp. at 898.
371 INT. REV. CODE OF 1954, § 1373.
373 INT. REV. CODE OF 1954, § 1373.
374 INT. REV. CODE OF 1954, § 1376(b)(2).
375 INT. REV. CODE OF 1954, § 1374(c).
oldest precepts of tax law requires that sham transactions be disregarded for tax purposes.377

The stockholders in *Wheat v. United States*378 asserted their personal guarantees of the Subchapter S corporation's outstanding loans constituted indebtedness owing from the corporation to the stockholders. Further, this indebtedness increased the shareholders' basis in their investment allowing a greatly increased writeoff of the corporation's losses. The court disposed of the taxpayer's assertion with a summary judgment for the government. There was no debt to the shareholders until the corporation defaulted on the loans and the shareholders were held liable on their personal guarantees. The court relied on holdings that the term "indebtedness" implies an existing unconditional and legally enforceable obligation to pay.379

The shareholders contended that their Stockholder’s Agreement established the requisite obligation to pay. The terms of the agreement required the stockholders to make additional contributions to capital whenever the financing of a project necessitated. The agreement was never employed, the corporation acquiring funds through bank loans. The agreement notwithstanding, the shareholders assumed no actual liability until such time as the corporation defaulted, and this never occurred.

The shareholders of a Subchapter S corporation can increase their basis in the corporate stock to enable them to absorb corporate losses. This can be accomplished through the corporation's retention of income, additional purchases of stock or the creation of actual indebtedness by the corporation to the shareholder, but the method employed must have economic substance to avoid being categorized as a sham transaction.

9.00 Inventory

9.01 Full Absorption Regulations. With the promulgation of the full absorption regulations,380 the Commissioner has extended an invitation to attorneys to join hands with certified public accountants and together wade into the deep, dark, murky waters of the world of cost accounting, where they will encounter strange creatures such as prime cost, direct cost, fixed and variable costs, period costs, practical capacity, etc., not fully realizing whether they are entering a quagmire or merely a bottomless pit.

The regulation places great stress upon the determination of the year-end inventory valuation for manufacturers, since ending inventory is a crucial item in calculating taxable income. The cost of goods manufactured and sold varies inversely and taxable income varies


379 *Tomlinson v. 1661 Corp.*, 377 F.2d 291, 295 (5th Cir. 1967); *United States v. Virgin*, 230 F.2d 880, 883 (5th Cir. 1956).

directly with inventory. Therefore, if ending inventory is understated, the cost of goods manufactured and sold will be overstated, thereby understating taxable profit and, of course, depriving the federal government of their share of the profit.

The regulation requires the full absorption of both direct and indirect costs for calculating inventory values, so as to conform to the best accounting practices and to clearly reflect income, as required by Section 471. Previously, Regulation 1.471-2(f)(6) and (7) refused to permit the direct cost or prime cost method to be used. The direct cost method segregates indirect costs between fixed and variable costs, allocating only the variable cost to inventory and expensing the fixed costs. The prime cost method results in all indirect costs, whether fixed or variable, being expensed.

The regulation defines direct production costs as "those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct labor or direct material."\(^{381}\) Direct labor includes labor performed directly on the specific product plus "overtime pay, vacation, holiday, sick pay, wage continuation under Section 105(d), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor."\(^{382}\) Direct material is defined in Section 471-3, but basically includes those materials which become an integral part of the product. All direct costs must be considered in determining inventory values.

Indirect production costs are defined to include "all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs."\(^{383}\)

Three categories of indirect costs are specified. Category 1 includes those elements of cost which must be included in the computation of inventoriable costs to the extent they are incident to the production process. Included are:

(a) repair expenses, (b) maintenance, (c) utilities, such as heat, power and light, (d) rent, (e) indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d), shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan, (f) indirect materials and supplies, (g) tools and equipment not capitalized, and (h) costs of quality control and inspection.\(^{384}\)

\(^{381}\) Treas. Reg. § 1.471-11(b) (2).
\(^{382}\) Id.
\(^{383}\) Treas. Reg. § 1.471-11(b) (3).
\(^{384}\) Treas. Reg. § 1.471-11(c) (2) (i).
Category 2, listed below, sets forth those costs not required to be included in the inventory costs regardless of taxpayer's treatment of such items on the financial statement:

(a) marketing expenses, (b) advertising expenses, (c) selling expenses, (d) other distribution expenses, (e) interest, (f) research and experimental expenses including engineering and product development expenses, (g) losses under Section 163 and the regulations thereunder, (h) percentage depletion in excess of cost depletion, (i) depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports, (j) income taxes attributable to income received on the sale of inventory, (k) pension contributions to the extent they represent past services cost, (l) general and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.385

Category 3 lists items which may be includable in inventory costs depending upon their treatment in taxpayer's financial statement. These costs include, but are not limited to the following items related to and necessary for production or manufacturing: (a) taxes which are deductible other than income taxes (e.g., real property taxes imposed on production facilities and personal property taxes imposed on inventory), (b) depreciation reported in financial reports and cost depletion, (c) pension and profit-sharing contributions to the extent they represent current service costs and other employee benefits, (d) costs attributable to strikes, rework labor, scrap and spoilage, (e) factory and administrative expenses, (f) officers' salaries which are incident to and necessary for the production or manufacturing operations or processes, and (g) insurance costs.386 Other costs not specifically enumerated, fall into the category to which they are most similar.

The previously mentioned indirect costs must be allocated to products in ending inventory by a procedure which fairly apportions costs among the items produced.387 The regulation permits the allocation to be based on either the use of a manufacturing burden rate method or the standard cost method.388 However, variances from the predetermined burden rate and standard cost must also be apportioned to inventory.

The regulation permits a portion of the fixed indirect (overhead)

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388 Treas. Reg. § 1.471-11(d)(2) & (3).
costs to be deducted currently when production falls below the practical capacity of the plant or facility. Practical capacity is either maximum or theoretical capacity based on the normal work week and the regular number of shifts, reduced by holidays, vacation time, down time and other unavoidable interruptions.

All manufacturers are required to adopt full absorption costing. However, an election to change during the two-year transitional period, after September 19, 1973, and before September 19, 1975, qualifies the taxpayer for special treatment. Taxpayers so electing obtain the benefits of spreading an increase in income, resulting from the inventory revaluation, forward over a ten-year period. Further, the election tolls action on issues currently raised by the IRS during an audit concerning inventory costing.

This regulation has far-reaching consequences upon the cost accounting system of every manufacturing company, whether it be Wagner Machine Shop or General Motors. In the future, litigation will abound over interpretations of this section due to the complexity and volume of the potential issues which may be raised by the Commissioner. 

10.00 Capital Gains and Losses

10.01 Repayment of Insider Profits. One of the questions most widely litigated involves the treatment of repayments of funds previously taxed at capital gains rates. The question arises from a rather "involuntary" repayment of gains from inside profits and other "fraudulent" transactions under threat of suit by the S.E.C. or some other injured party. The taxpayers originally treated the gains as long-term capital gains but deducted the repayments as ordinary business losses resulting in a tax gain on the overall transaction. The question was presented to the Supreme Court under a different factual situation in Arrowsmith v. Commissioner. The rule set forth in Arrowsmith was made clear in another Supreme Court decision United States v. Skelly Oil Co.

The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in Arrowsmith was unwilling to infer that Congress intended such a result.

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To apply the rationale, the two transactions, original receipt of funds and a subsequent repayment, must be integrated and viewed as one transaction. The Tax Court has refused to find such a relationship arising from a violation of Section 16(b) of the Securities Exchange Act of 1934.\footnote{Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p (1934).} In these cases\footnote{b} the taxpayer, a director or officer of the corporation, has usually asserted that the repayments were made for valid business reasons, to protect his business reputation and to avoid future litigation. The taxpayer was deemed to have recognized capital gains in the capacity of a shareholder but paid the alleged insider's profits as an officer of the corporation. There being no connection between the two acts, the Tax Court asserted the Arrowsmith rule does not apply.

The circuit courts have consistently found the Tax Court's construction of the transactions unpersuasive. The Seventh Circuit found "the 16(b) payments were 'inextricably intertwined with taxpayer's... stock transactions.' Bifurcating the sale and payments smacks of artificiality, and characterizing the sale-purchase occurrence as without tax significance could only have been done in a vacuum."\footnote{There is no distinction between the taxpayer's status at the time of the stock transaction and the subsequent repayment of the profits. The taxpayer sold the stock as an insider and the demand for repayment was addressed to him in the same capacity.}

In all of these cases the repayments were "voluntary" in that the 16(b) violation had only been alleged and no suit was ever filed for the recovery of the profits. From this the Tax Court determined that the taxpayer's motive in making the repayments could have only been to preserve his employment and to avoid injury to his business reputation. That the taxpayers were liable under 16(b) was unquestioned and there was no reason to allow the taxpayer an ordinary deduction merely because he paid promptly instead of awaiting litigation.

The purpose of 16(b) is to prevent unfair profit by the use of information available only to an insider. Whether the insider actually had such information is immaterial under the statute. The purpose of 16(b) would be severely undermined by allowing the repayment of the profits...
to be deductible as an ordinary business expense. If the ordinary loss is allowed the government is in effect subsidizing the repayment to the extent of the difference in the ordinary and capital gains tax rates. There hardly seems to be a case, under the view taken by Tax Court, that would not qualify for an ordinary deduction, because the taxpayer will always honestly be able to assert that a finding of insider profiteering would damage his business reputation.

A District Court in the Fifth Circuit has applied the rationale of the other circuits in the previous cases in holding that a settlement under threat of suit is a capital loss. The taxpayer sold two leases on oil wells that were illegally slanted and treated the profits as capital gains. A bank that held a security interest in the oil production from the wells threatened a lawsuit against the taxpayer as a result of the purchaser's default. The bank asserted that the taxpayer knew the wells were illegally producing when he sold the leases and that taxpayer also knew the bank was providing the financing. The taxpayer agreed to settle the lawsuit "because a lawsuit, even though it be without basis, charging him with fraud would have an adverse effect on his reputation and operations in the oil and gas business." The court found Arrowsmith to be clearly applicable—to hold otherwise would allow the taxpayer a double deduction. The original payment, treated as a capital gain, and the subsequent settlement (repayment) arose from the same transaction—the sale of the oil leases. As a result the loss must be treated in the same manner as the original gain—as a capital transaction.

A taxpayer who is involved in a transaction similar to those set forth above should choose the Tax Court as the forum to litigate his case. The Tax Court appears to be rather adamant in its position. Even though it agreed to rehear Cummings in light of the reversal of its opinion in Anderson, the court maintained its position that the repayments were an ordinary business expense. If Cummings is appealed it will be to the Second Circuit and in view of the holdings in three other circuits it seems likely that the Tax Court will again be reversed.

10.02 Corporate Loss on Sale of Non-Business Property. Can a corporation sustain a loss that would not be deductible under Section 165? The Seventh Circuit in International Trading Co. v. Commissioner reversed a Tax Court decision and found the answer to be clearly no. In a preceding case, International Trading Co. v. Commissioner, involving the same property, it was held that International could not deduct expenses

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398 Id. at 1233.
399 International Trading Co. v. Comm'r, 484 F.2d 707 (7th Cir. 1973), rev'd, 57 T.C. 455 (1971).
and maintenance cost or depreciate property used as a resort for the corporation's employees. The property was not property used in the trade or business. In 1957 International sold the resort property sustaining a $300,000 loss on the transaction. A deduction in this amount was taken on the corporation's tax return as provided in Section 165(a).\(^4\) In an attempt to be consistent with its prior holding in the first International case the Tax Court disallowed the loss deduction on the sale of the non-business property.

The circuit court found clearly dispositive differences between the sections of the Code relating to expenses and depreciation and Section 165 relating to losses. The general rule allows a deduction for all uncompensated losses and only limits deductions in the case of individuals.\(^5\) The Tax Court asserted that to allow the deduction would in effect give the taxpayer the benefit of depreciation on the property. The circuit court recognized this fact, but found "no license for judicial legislation in the fact that a taxpayer may achieve benefits under one section of the Code when what might seem to be the same benefits are denied under another section."\(^6\)

10.03 Sale of a Patent Pending. Would-be inventors who contemplate a sale of their patentable invention to a controlled corporation should make the transfer prior to receipt of the patent. A patent is a depreciable asset.\(^7\) Under Section 1239 gain on the sale of depreciable property to a controlled corporation will be treated as ordinary income. A mere application for a patent does not constitute depreciable property and therefore does not come under Section 1239.\(^8\) A patent application at some point in its processing does become sufficiently mature to be treated as a patent. In *Stahl v. Commissioner*\(^9\) a patent application was considered matured after the taxpayer received notification that some of his claims appeared allowable. Therefore, waiting until the application has been approved, even if only in part, may prove fatal as to capital gains treatment.

10.04 Sale of Dirt. Royalty payments under a mineral lease are considered ordinary income.\(^10\) Normally, the vendor's receipts depend

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\(^4\) *Int. Rev. Code of 1954*, § 165. "(a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."


\(^6\) 484 F.2d at 711.

\(^7\) Treas. Reg. § 1.167(a)(3). "...an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights."

\(^8\) Chu v. Comm'r, 486 F.2d 696 (1st Cir. 1973).

\(^9\) *Stahl v. Comm'r*, 442 F.2d 324, 328 (7th Cir. 1971).

upon the actual amount of minerals removed.\textsuperscript{408} However, to achieve capital gains treatment, the receipts must be solely dependent upon the vendee's \textit{right} to remove materials from the property and not the \textit{amount} he actually removes.\textsuperscript{409}

In \textit{Richard Ellis},\textsuperscript{410} the taxpayer contracted for the construction of a pond and sold the dirt extracted to the contractor. The trial court found the vendor's receipts depended solely upon the actual amount of dirt removed and were ordinary income. However, the Seventh Circuit determined, in an unreported decision, that the dimensions of the pond were sufficient to show the exact amount of dirt purchased, indicating an unconditional sale of mineral rights as opposed to royalty payments. The court accorded the transaction capital gains treatment.\textsuperscript{411}

\textbf{10.05 Sale of Partnership Interest.} The sale or exchange of a partner's entire interest has been treated as a capital gain or loss since the interest in a partnership is considered a capital asset.\textsuperscript{412} A sale by a partner closes the firm's taxable year as to him and at this date his distributive share of the earnings is determined.\textsuperscript{413} The gain or loss realized is computed by the difference between the amount realized and the adjusted basis of the partner's interest.\textsuperscript{414}

In a recent case\textsuperscript{415} two promoters agreed with an oil company to build a processing plant and supply the company's gas needs. The oil company entered a limited partnership agreement under the stipulation that the partners provide 40 percent (20 percent by each) of the financing needed for construction. When the promoters' financing did not materialize, the company brought out the entrepreneurs for $50,000 each, the latter relinquishing their rights and interests in the joint venture. Each reported $47,000 as capital gain. The IRS contended that the $100,000 was payment for services, thus ordinary income. The Tax Court found this a sale of a capital asset from which capital gains treatment evolved. It found the sale or exchange requirement met when the partner's right to share in the project as an equity holder was terminated.\textsuperscript{416}

\begin{thebibliography}{9}
\bibitem{footnote1} Commissioner \textit{v. Southwest Exploration Co.}, 350 U.S. 308 (1956); \textit{Rutledge v. United States}, 428 F.2d 347 (5th Cir. 1970); \textit{Laudenslager v. Comm'r}, 305 F.2d 686 (3d Cir. 1962).
\bibitem{footnote3} 56 T.C. 81 (1965).
\bibitem{footnote5} \textit{Morse v. United States}, 371 F.2d 474 (Cl. Cl. 1967); \textit{Forman v. Comm'r}, 352 F.2d 466 (3d Cir. 1965); \textit{United States v. Shapiro}, 178 F.2d 459 (8th Cir. 1949); \textit{United States v. Adamson}, 161 F.2d 942 (9th Cir. 1947).
\bibitem{footnote6} \textit{Treas. Reg.} § 1.706-1(c) (2).
\bibitem{footnote7} \textit{Treas. Reg.} § 1.705-1(a).
\bibitem{footnote9} \textit{Norman v. United States}, 296 F.2d 27 (9th Cir. 1961).
\end{thebibliography}
A wise promoter, who is fortunate enough to find a willing investor who will buy out the promoter's rights, may expect a capital gains treatment once sufficient evidence is presented to show a sale or exchange occurred. The evidence will frustrate a counter argument that the purchase price was payment for services disguised as the sale of a capital asset.

10.06 Installment Sales. A taxpayer, who qualifies under Section 453, can avoid the sometimes harsh consequences of full realization of gain on the sale of real or personal property by structuring an installment sale. Section 453 is limited to the following transactions: (1) sales by dealers in personal property who regularly sell on the installment plan, and (2) casual sales of non-inventory personal property for a price in excess of $1,000, and of real property, if payments do not exceed 30 percent of the selling price in the year of sale. The sale must be satisfied by at least two payments made in separate years; however, the first payment need not occur in the year of sale. 4 1 7 While the provisions appear self explanatory, the taxpayer who elects to be taxed under Section 453 should be aware that traps do exist.

The 30 percent limitation in the year of sale presents such a trap. Payments made in prior years that are applied to the selling price are included in the payments made in the year of sale. 4 1 8 Assume the selling price is $100,000 and on December 20th purchaser makes a $5,000 forfeitable down payment, but the sale is not completed until the following year. Seller elects to make an installment sale and requests that $29,000 be paid at closing, not realizing that the down payment is considered part of the first installment. Since the sum of the payments exceeds 30 percent of the selling price in the year of sale, the taxpayer may not elect to be taxed under Section 453. The result is that the entire gain on the sale will be taxable in the year of sale, even though the seller has not received full payment.

If the purchaser assumes a mortgage encumbering the property, to the extent that the mortgage exceeds the seller's adjusted basis, such assumption of liability by the purchaser constitutes a payment in the year of sale. 4 1 9 The calculation of the seller's adjusted basis in the property has a direct effect on the amount of payment made in the year of sale and whether the 30 percent limitation is met. The Tax Court in Walter Kirschenmann 4 2 0 held that selling cost should be deducted from the total selling price and not added to the seller's adjusted basis. The Ninth

419 Treas. Reg. § 1.453-4(c).
Circuit disagreed with the Tax Court and held that selling expenses are an adjustment to seller's basis in the property.

The Commissioner contended that the inclusion of selling expense in adjusted basis causes internal inconsistencies in the regulations. Treasury Regulation Section 1.453-1(b)(1) defines gross profit as selling price less adjusted basis and further that gross profit is then "reduced by commissions and other selling expenses for the purpose of determining the proportion of installment payments returnable as income."\(^{421}\) A second inconsistency is created in Treasury Regulation Section 1.453-4(c). The regulation provides, "Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments...."\(^{422}\) Since the excess of assumed mortgage over basis is a payment in the year of sale, adding selling cost to basis will reduce the amount of the payment in the year of sale.

The Ninth Circuit held that the inconsistencies were created by the measure of the term "adjusted basis" in the regulations and stated:

[W]e decline to adopt a meaning of "adjusted basis" that is contrary to Subsections 1011 and 1016 of the Code in order to rectify the inconsistencies.

We do not hold that the Section 1016 meaning of "adjusted basis" is always controlling when that term is used in a Treasury Regulation. We hold only that Treasury Regulation Section 1.453-4 (c) does not present an appropriate case for departing from the Section 1016 definition.\(^{423}\)

If no interest is provided for in the sales agreement interest will be imputed under Section 483.\(^{424}\) The selling price will be reduced by the amount of interest imputed, thus, if the initial payment was precisely 30 percent of the total selling price, the actual payment in the year of sale would exceed 30 percent and the Section 453 election would be disallowed.

The interest imputed is treated as ordinary income, however, if the sale is exempted under Section 483(f) the seller may receive capital gains treatment. The taxpayer in Busse v. Commissioner\(^{425}\) sold a patent in a transaction described by Section 1235, but was precluded from treatment under that section because the taxpayer was "related" to the purchaser. The court upheld the taxpayer's contention that interest could not be imputed to the sale because of the protection offered by Section 483(f)(4), even though he was required to establish capital gains treatment under

\(^{421}\) Treas. Regs. § 1.453-1(b)(1).

\(^{422}\) Treas. Regs. § 1.453-4(c).

\(^{423}\) CCH 1973 U.S. Tax Cas. ¶ 9799 (9th Cir. Nov. 11, 1973).

\(^{424}\) The present rate at which interest is imputed is 5 percent. If the contract calls for at least 4 percent no interest will be imputed. Treas. Regs. § 1.483-1.

\(^{425}\) Busse v. Comm'r, 479 F.2d 1147 (7th Cir. 1973).
Sections 1221 and 1222. The court found the regulations on Section 1235 [256] to be ambiguous when compared with the plain meaning of the section, and to that extent the regulations are not controlling.

Difficulties sometimes arise as to what constitutes a payment in the year of sale. Where an initial payment is made and the purchaser remains obligated to make payments over a period of future years Section 453 would seem to apply. In one situation the purchaser paid the purchase price into escrow to be paid out over a six-year period, and continued to be liable on all unpaid installments. Even so, the IRS held the transaction was complete when the funds were deposited with the escrow agent and the sale did not qualify as an installment sale.\(^{427}\) The proceeds of the sale were constructively received by the seller; it is immaterial that the seller agreed to allow a third party to hold the proceeds and to pay them to the taxpayer at a later date.\(^{428}\) In a second situation after the initial payment, pursuant to a contract, the seller accepted nine equal interest-bearing notes due over the following nine years. In this matter the IRS held the sale qualified for installment treatment.\(^{429}\) Although Section 1.453-4 of the Treasury Regulations provides that the vendor's interest must be protected by a mortgage or lien, the notes were held sufficient even though the property was transferred to the purchaser unencumbered. The seller retained no interest in the property, and his only recourse was on the notes of the purchaser. In the year of sale the seller has received little more in the first situation than in the second. In the first the risk factor is less, but in the event the escrow agent fails to make the payments when due the purchaser remains obligated. The purchaser's obligation in the second situation is continuous and primary from the date of sale. The differences are not so great as to require a different result.

11.00 Tax Credits
11.01 Investment Credit Carryback and Carryover—Cooperatives. Normally investment tax credits can be carried back three years and carried forward seven years, subject to certain limitations. In a case of first impression, *Helena Cotton Oil Co., Inc.*,\(^{430}\) the Tax Court held that the credit available to a cooperative in a year in which it had no income cannot be carried back or carried over. Section 46(d) limits the carryover or carryback available to certain classes of taxpayers. The ratable share available to a cooperative is determined by a ratio, the numerator of which is its taxable income. If the numerator of a ratio is zero, any amount multiplied by the ratio will result in an indeterminate result.

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\(^{426}\) Treas. Reg. § 1.483-2(b) (4).


\(^{428}\) Harris v. Comm'tr, 477 F.2d 812 (4th Cir. 1973).


\(^{430}\) Helena Cotton Oil Co., Inc., 60 T.C. No. 16 (April 25, 1973).
The court held that since the result is indeterminate the taxpayer cannot show what amount its ratable share of the investment is. Therefore, no carryover or carryback is permissible.

Normally a cooperative receives only a small investment credit because only a small part of its income is taxed to the cooperative,\(^{431}\) the excess credit being lost. The Tax Court's decision is interesting and mathematically correct.

12.00 Privilege

12.01 Attorney-Accountant Client Privilege. A fundamental element of an attorney's professional responsibility is the preservation of his confidential communications with his client.\(^{42}\) The policy reason for the privilege is the encouragement of open and frank consultation between the attorney and client, absent a fear that what is said may later be disclosed.\(^{433}\) Courts confronted with this issue often dwell on the scope and breadth of the privilege, apparently presuming its existence.\(^{434}\) The "federal rule" for the privilege is attributed to United States v. United Shoe Machinery Corp., an anti-trust proceeding which recognized the existence of the privilege, if:

(1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceedings, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.\(^{435}\)

Section 7602 of the Code has served as the avenue from which the IRS has questioned the attorney-client relationship and privilege. The statute provides in part:

For the purpose of ascertaining the correctness of any return, ... determining the liability of any person for any internal revenue tax ... or collecting any such liability, the Secretary or his delegate is authorized—


\(^{433}\) 8 J. Wigmore, Evidence, 2291 (Rev. ed. 1961).


(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax...or any person having possession, custody or care of books of account containing entries relating to the business of the person liable for tax...or any other person the Secretary or his delegate may deem proper, to appear...and to produce such books, papers, records or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath as may be relevant or material to such inquiry.436

The exact scope of the attorney-client privilege has not been uniformly defined to date since the choice of law has resulted in conflict among the circuits. In Colton v. United States,437 the Second Circuit sustained its prior position438 that the question of privilege, in a case involving federal income tax investigations, is a matter of federal law. This contradicts the Ninth Circuit's position finding state law determinative.439

When a taxpayer selects an attorney to complete his tax returns and to prepare sundry other documents, the issue is neatly drawn as to whether the privilege will extend to these papers and work products within the attorney's possession. Application of the privilege to the client's identity,440 the nature of the services rendered, fees charged and general tax records have been successfully resisted by the IRS.

However, the preparation of tax returns and the rendering of tax advice have been found to constitute a substantial part of the services rendered by an attorney as a part of his professional competence. In Colton, they were described as prima facie subject to the attorney-client privilege. The statement, however, was not without qualification, "particularly in the case of an attorney preparing a tax return" where a great deal of the information communicated "is not intended to be confidential, but rather is given for transmittal by the attorney to others—for example, for inclusion in the tax return."441 Furthermore, the individual asserting the privilege must show conclusively that the matters were communicated to

438 In re Albert Lindley Lee Memorial Hospital, 209 F.2d 122 (2d Cir. 1953). Accord, Falsome v. United States, 205 F.2d 734 (5th Cir. 1953); United States v. Brunner, 200 F.2d 277 (6th Cir. 1953).
441 306 F.2d at 638.
the attorney in his professional capacity.\textsuperscript{442} This alone may be an awesome burden of proof. In \textit{United States v. Gurtner},\textsuperscript{443} the court found that if a timely objection is not raised by the taxpayer as to the admissibility of certain evidence to which the privilege might apply, the objection is waived. The taxpayer had been advised by his attorney to consult with an accountant. Even though a working relationship existed between both the attorney and the accountant the privilege was extended only to the confidential communication seeking legal advice from an attorney. Thus, where only an accounting service is sought, the privilege may not exist.

Consequently, an interesting dilemma is presented when an attorney is employed to function both as a legal consultant and as an accountant. Though it may appear difficult, if not impossible, to separate the communications made to him in each of these capacities, the privilege is necessarily limited to those communications occurring only during the rendition of legal services. In \textit{Olender v. United States},\textsuperscript{444} the attorney-accountant was employed to prepare a net worth statement, following the initiation of an investigation by the IRS. The district court held that testimony concerning accounting matters was not privileged. This was premised upon the court’s finding that he had been employed primarily as an accountant; and this finding was supported by the Ninth Circuit. This rationale seems to indicate that the preparation of a federal income tax return is not a legal service to which the attorney-client privilege applies. Further, if the attorney is also an accountant the inference arises that while preparing a client’s income tax return the individual is not acting as an attorney. Thus, the argument against application of the privilege is seemingly strengthened.\textsuperscript{445}

A further extension of this dilemma arises when the attorney, though actually rendering legal services to which the privilege applies, is consulted after the taxpayer confers with an accountant as occurred in \textit{United States v. Kovel}.\textsuperscript{446} A rather arbitrary line was admittedly drawn by the court between a situation where a client communicates first to his own accountant (a non-privileged communication) and an attorney is later consulted on the same matter, and situations where in the first instance the client consults an attorney while the client’s accountant is present. In

\textsuperscript{442} Lowy v. Comm’r, 262 F.2d 809 (2d Cir. 1959), where the attorney and client were mutually engaged in business transactions. Pollock v. United States, 202 F.2d 281 (5th Cir. 1953), where the attorney acquired real estate for his client. McFee v. United States, 206 F.2d 872 (9th Cir. 1933), where the attorney executed financial transactions for the client, similar to services a banker might provide.

\textsuperscript{443} United States v. Gurtner, 474 F.2d 297 (9th Cir. 1973).

\textsuperscript{444} Olender v. United States, 210 F.2d 795 (9th Cir. 1954).

\textsuperscript{445} In re Fisher, 51 F.2d 424 (S.D.N.Y. 1931). The privilege was held to be inapplicable to communications to one acting as both attorney and accountant, when made to facilitate the auditing of the client’s books. See Lofts \textit{supra} note 435, at 419.

\textsuperscript{446} United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).
the latter situation the communications are privileged. The distinction was found to be, "[T]he inevitable consequence of... reconcil[ing] the absence of a privilege... of the client and lawyer under conditions where the lawyer needs outside help." 447 This seemingly contradicts the rationale of United States v. Cote 448 where the privilege was extended to memo-
randa and working papers prepared for the taxpayer by his accountant at the attorney's request so as to render legal advice concerning the advisability of filing an amended tax return.

In addition to contentions of privileged communication between attorney and client, significant constitutional issues are raised with respect to self-incrimination. In Couch v. United States, 449 the taxpayer challenged a summons directing her accountant to produce business records acquired for preparation of her tax returns. The taxpayer invoked her fifth amendment privilege against compulsory self-incrimination to prevent production of her business and tax records. However, both the district court and the circuit court concluded that the privilege was unavailable. The Supreme Court held that since the taxpayer had voluntarily parted with possession of these records, there was no personal compulsion against producing the records. Since much of the information in the records was to be disclosed in income tax returns, there was no legitimate expectation of privacy barring production. Therefore, possession, not ownership, appears to be the catalyst supporting a self-incrimination argument. This conclusion is supported in United States v. White 450 which denied a claim of privilege against self-incrimination because the taxpayer did not possess any of the documents sought by the IRS. The taxpayer's attorney had maintained possession for an extended period of time; a point used to defeat a constructive possession argument.

With respect to the privileged communication enjoyed in certain select professions, practitioners may be shocked to learn of a recent decision in Texas. A startling announcement in McNatt v. United States may signal the end of at least one area of preferred treatment. The court declared: "Plaintiff may not claim a bookie-client privilege." 451

447 Id. at 922.
448 United States v. Cote, 456 F.2d 142 (8th Cir. 1972).
450 United States v. White, 477 F.2d 757 (5th Cir. 1973).