FEDERAL INCOME TAX DEVELOPMENTS: 1980

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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1980 is the eighth of an annual series of articles to be published in the AKRON LAW REVIEW. The scope of this survey is limited to the substantive developments in the field of income taxation. The thrust of this article is not only to identify new developments, but also to trace these concepts through their formulative changes.

Given the volatile nature of taxation, it is crucial for the practitioner in this field to remain current with the changes which have occurred during the year. Research of this article includes cases decided through August 31, 1980.

In an attempt to minimize the lead time between research and publication, this author has engaged the most able assistance of several members of the AKRON LAW REVIEW. Without their substantial contributions and complete dedication, this article would not have been possible. The author, therefore, wishes to recognize and thank the following members of the AKRON LAW REVIEW, for their efforts in researching, writing and compiling this article Alan J. Tobin, Richard P. Hodge, William R. Meyers, Kevin C. O'Neil, Kevin L. Pelanda, and David A. Shepherd. Special appreciation is extended to Alan J. Tobin.

TABLE OF CONTENTS

Paragraph

1.00 Income
1.01 Meal Allowance
1.02 Dividend and Interest Exclusion

2.00 Deductions
2.01 Attenuated Business Expenses
2.02 Depreciation—Going Concern Value
2.03 Illegal Cash Rebates

3.00 Exemptions

4.00 Deductions
4.01 Education Expenses—Psychoanalysis
4.02 Penalty Damages
4.03 Tax Shelter

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Paragraph

5.00 Tax Credits
5.01 Investment Tax Credit
5.02 Energy Credit

6.00 Depreciation

7.00 Gains and Losses
7.01 Nonrecognition—Principal Residence—Yacht

8.00 Procedure
8.01 Attorney Fees
8.02 Audit Workpapers
8.03 Handwriting Exemplars
8.04 Jury Awards
8.05 Statute of Limitations
8.06 Tainted Evidence
8.07 Tax Preparer's Negligence Penalties
8.08 Taxpayer Compliance Measurement Program

9.00 Inventory
9.01 Inventory Writedowns

10.00 Pension, Profit Sharing and Stock Ownership Plans
10.01 Advance Funding
10.02 Disability Payout
10.03 Integration of Workers' Compensation Benefits
10.04 Limitation on Benefits Raised
10.05 Professional Corporation—Pension

11.00 Corporations
11.01 Dividend In Kind
11.02 Liquidation—Basis Valuation
11.03 Liquidation—Reorganization
11.04 State and Local Taxes
11.05 Type B Reorganization
11.06 Waiver of Family Attribution Rules

12.00 Subchapter S Corporations
12.01 Ownership by Children

13.00 Estate Planning
13.01 Basis of Property
13.02 Disclaimers
13.03 General Power of Appointment
13.04 Life Insurance
13.05 Redemption
1.00 Income

1.01 Meal Allowance

Early this year the Supreme Court denied certiorari in the case of Hotel Conquistador, Inc. v. United States.¹ The issue involved in the case was whether employers are required to pay federal social security taxes (FICA) and federal unemployment taxes (FUTA) on meals furnished to employees on the employer's premises. The Court of Claims determined that such meals did not constitute remuneration when furnished for the employer's convenience.²

Meals were served to employees of the Tropicana Hotel in Las Vegas during working hours in the hotel cafeteria. Hotel policy provided that meals be furnished at reduced prices or free of charge to qualified employees. The Court of Claims found such meals were furnished for the convenience of the employer, that is, in order to keep employees on the premises. As such, these meals were not part of the employees' wages and their value could not be used for the purpose of computing FICA or FUTA taxes.³ As a result, the hotel was granted a refund on FICA and FUTA taxes paid on such included meals.

It should be noted that the refund criteria under the Conquistador case differs from the criteria for exclusion from gross income under section 119.⁴ Under section 119, the furnishing of meals and lodging to an employee or his spouse and dependents is excludable from gross income as long as it is for the convenience of the employer. Also, such meals and/or lodging must be furnished in kind and on the employer's premises and, in the case of lodging, it must be a condition of employment.

When considering whether to request a refund, one should look to the value of the meals as related to total compensation and the existence of any substantial conditions precedent to receiving such meals. If these facts indicate that the meals were meant to be additional remuneration, then a refund request may not be in order.

1.02 Dividend and Interest Exclusion

The Crude Oil Windfall Profit Tax Act increases the dividend exclusion and extends the exclusion to apply to certain types of interest for the tax years 1981 and 1982.⁵ The Act increases the dividend exclusion to $200 for individual taxpayers, and increases the exclusion for married couples filing

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¹ 597 F.2d 1348 (Ct. Cl. 1979), cert. denied, 100 S. Ct. 702 (1980).
² Id. at 1350.
³ Id.
⁴ See Int. Rev. Code of 1954. All subsequent references to code sections are to the Internal Revenue Code of 1954 unless otherwise indicated.
jointly up to $400. This $400 limit for married couples filing jointly will apply without regard to which spouse receives the interest or dividend income.\(^6\)

The exclusion will also extend to certain types of interest from domestic sources earned by individuals, with the same $200 and $400 limitations. The most common types of interest that will be eligible for the exclusion are interest received from a bank or savings and loan association or credit union, and interest on bonds issued by a domestic corporation in registered form.

2.00 Deductions

2.01 Attenuated Business Expenses

The Tax Court, in Harold Dancer v. Commissioner,\(^7\) distinguished the longstanding Freedman\(^8\) case in the area of attenuated business expense deductions. In Dancer, the taxpayer was faced with a $140,000 judgment stemming from an automobile accident. Dancer's insurance carrier satisfied $100,000 of the judgment, leaving Dancer to pay the remaining $40,000. Upon payment, Dancer deducted the $40,000 under section 162 as an ordinary and necessary business expense. The Service disallowed the deduction arguing an absence of business intent in the taxpayer's travel. Dancer, as a horse trainer, had three business locations, his farm, his home and stable, and the racetrack. The accident in question occurred as he traveled from his farm to his home, where he was to have lunch and attend to his horses.

The Fifth Circuit in Freedman had disallowed a business deduction of money paid to satisfy a judgment arising out of an auto accident.\(^9\) The deduction was disallowed because the accident occurred while the taxpayer was traveling between two unrelated business ventures. The Fifth Circuit found the accident to be merely incidental to the travel and to have no connection with either business.

The Tax Court determined that Dancer's trip was between two locations of one business as distinguished from Freedman's travel between two unrelated business ventures. The Tax Court, in allowing the business deduction in Dancer, looked to the intent of the taxpayer in making the trip.

It is important to note that, in concurring opinions, seven judges expressed the belief that Freedman should have been overruled totally in order to avoid confusion in the application of the Dancer decision, and thus keep future cases out of court.

\(^6\) Id. at § 404.
\(^7\) 73 T.C. 1103 (1980).
\(^8\) Freedman v. Comm'r, 35 T.C. 1179 (1961), aff'd at 301 F.2. 359 (5th Cir. 1962).
\(^9\) Id. at 1181.
2.02 Depreciation—Going Concern Value

The Sixth Circuit\(^ {10} \) and the Tax Court\(^ {11} \) recently established that the going concern value, in the purchase of an ongoing business, can not be allocated to a tangible depreciable asset for depreciation purposes. This position was taken with respect to the 1964 purchase of the K-D Lamp Division of the Dupean Corporation by Concord Control. The Tax Court went on to determine that, at the time of the K-D purchase, no valuable goodwill existed due to the highly competitive nature of K-D's business. Both the Sixth Circuit and the Tax Court agreed that at the time of the transaction K-D possessed a trained staff and an established product line ready for sale in addition to depreciable equipment. The Tax Court defined going concern value as "the increase in the value of assets due to their existence as an integral part of an ongoing business."\(^ {12} \)

The decision by the Sixth Circuit points out the inconsistency among the circuits. The Tenth Circuit has held that the cost of depreciable property can include going concern value.\(^ {13} \) This position is directly opposed to that taken by the Sixth, Eighth\(^ {14} \) and Ninth\(^ {15} \) Circuits which hold that the depreciable basis of assets should not include going concern value. An early resolution of this conflict is needed to aid in the valuation of purchased ongoing business operations.

2.03 Illegal Cash Rebates

Section 162(c)(2) bars a business expense deduction for illegal bribes or kickbacks which subject the payor to a criminal penalty or loss of license or privilege to engage in a trade or business.

The Tax Court in *Pittsburgh Milk Co. v. Commissioner*\(^ {16} \) decided that illegal rebates in cash or kind were part of the cost of goods sold and therefore proper to reduce gross income. The court felt that to exclude these rebates from the cost of goods sold would be imposing a tax on gross receipts which is not allowed under the income tax law. Only the actual gross income can be subject to income tax.

In 1976, the Service issued Revenue Ruling 77-244\(^ {17} \) which declared that illegal payments within the meaning of section 162(c)(2) of the Code may not be subtracted from gross sales to determine gross income. Therefore, where the taxpayer bills milk to retailers at the fixed minimum

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\(^{10}\) Concord Control, Inc. v. Comm'r, 615 F.2d 1153 (6th Cir. 1980).

\(^{11}\) Concord Control, Inc., 45 T.C.M. (P-H) ¶ 76, 301 (1976).

\(^{12}\) Id. at 1333.

\(^{13}\) Comm'r v. Texas - Empire Pipe Co., 176 F.2d 523 (10th Cir. 1949).

\(^{14}\) Northern Natural Gas Co. v. United States, 470 F.2d 1107 (8th Cir. 1973).

\(^{15}\) United States v. Cornish, 348 F.2d 175 (9th Cir. 1965).

\(^{16}\) 26 T.C. 707 (1956).

\(^{17}\) 1977-2 C.B. 58.
price as determined by state law, but gives rebates in violation of the law to bring the price below the minimum, no deduction will be allowed for the rebates whether in cash or kind. Since the payments would be disallowed as a business expense, they will also be disallowed as a reduction of gross income. Furthermore, Treasury Regulation 1.61(3)(a) determines gross income without the subtraction of amounts disallowed under section 162(c) in the case of a business expense.

The Service's position has been tested in three cases since Revenue Ruling 77-244\textsuperscript{18} was issued. In \textit{Max Sobel Wholesale Liquors v. Commissioner}\textsuperscript{19} a wholesale liquor dealer sold twelve bottles of wine at the minimum fixed price set by the state and later gave one extra bottle free. The extra bottle of wine was given to avoid the price controls set by the state. The Service claimed that the dealer could not deduct the cost of the extra bottle of wine as a cost of goods sold or a deduction from gross receipts since it was an illegal payment barred by section 162(c)(2). The Tax Court disagreed and followed the \textit{Pittsburgh Milk} decision in deciding that the illegal payments were not barred by section 162(c)(2) because the payments were deducted from sales to arrive at gross income.

The same reasoning was followed by The Tax Court in two other cases involving the payment of cash rebates. In \textit{Haas Brothers, Inc. v. Commissioner}\textsuperscript{20} a wholesale liquor dealer gave cash rebates instead of merchandise rebates. The Tax Court decided that the cash rebates were not distinguishable from the merchandise rebates. Further, the Tax Court said that the rebates were part of the actual sales transaction and should be treated as a reduction in gross income instead of a business deduction under Section 162.

The Tax Court has followed \textit{Haas Brothers} in a 1980 case, \textit{Dixie Dairies Corporation v. Commissioner},\textsuperscript{21} which involved illegal cash rebates paid by milk wholesalers. The court here again looked at the economic realities of the transaction, finding that the rebates were part of the actual sales transaction instead of a business deduction. Still, the issue of illegal rebates has not yet been fully resolved; \textit{Max Sobel} is currently on appeal to the Ninth Circuit.

3.00 Exemptions

4.00 Deductions
4.01 Education Expenses—Psychoanalysis

Education expenses may be deductible as ordinary and necessary

\textsuperscript{18} \textit{Id.}
\textsuperscript{19} 69 T.C. 477 (1977).
\textsuperscript{20} 73 T.C. 1217 (1980).
business expenses if the education maintains or improves skills required by
the taxpayer in his employment or other trade or business, or meets the
express requirements of the individual’s employer. However, even if the
educational expenses meet the above requirements, they will not be de-
ductible if they are required of the taxpayer to meet the minimum educa-
tional requirements for qualification in his employment or other trade or
business, or if they qualify the taxpayer for a new trade or business.

In *Harry H. Voigt*, the taxpayer, a clinical social worker, decided
to undergo psychoanalysis to improve her skills as a psychotherapist. The
psychoanalysis was not taken at an accredited psychoanalytic institute. The
taxpayer deducted the cost of the psychoanalysis as an educational expense.

The Service argued that the taxpayer's educational expenses were not
deductible because they: 1) were undertaken to meet the minimum re-
quirements of her employer; 2) were taken to qualify the taxpayer for a
new trade or business; and, 3) were not directly and proximately related
to improving skills required for taxpayer's employment.

In an earlier Tax Court case, a practicing physician specializing in
internal medicine had voluntarily taken courses in psychoanalysis although
the courses were not required in order to retain his job. The court there
held that such educational expenses were deductible because the physician
improved his skills enabling him to do a more competent job. Furthermore,
the skills that he acquired did not qualify him for a new specialty, but
merely sharpened his skills in internal medicine.

In the instant case, psychoanalysis was not necessary for the taxpayer
to meet the requirements of being a clinical social worker. The psycho-
analysis was a program to improve the taxpayer’s skills at the job and was
not merely for self-improvement. Such programs do not have to be limited
to formal education since Treasury Regulation 1.162-5(b) implicitly ac-
knowledges the educational nature of psychoanalysis.

In addition, the psychoanalysis did not qualify the taxpayer for any
new licenses nor was it a prerequisite for obtaining employment as a clinical
social worker. The taxpayer continued her employment as a clinical social
worker while undergoing psychoanalysis. Treasury Regulation 1.162-5(b)
(3) states that an employer-directed change of duties does not constitute a
new trade or business if the new duties involve the same general type of
work as is involved in the taxpayer's present employment. Although the
taxpayer improved her skills for treating her patients, her duties after the

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23 Treas. Reg. § 1.162-5(b)(2) & (3).
training involved the same general type of work as before. The training did not qualify her for a new trade or business.

The psychoanalysis was an educational expense having a direct and proximate relationship to her employment. The taxpayer benefited from the psychoanalysis by acquiring skills that separated her own personality conflicts from that of her patients so that she could better diagnose and treat her patients. Furthermore, the taxpayer received more referrals from psychiatrists and other mental health professionals after undergoing psychoanalysis. Since this integral relationship between the taxpayer's employment and the educational expense existed, the cost of psychoanalysis was properly deductible as an educational expense. It did not affect the outcome that the taxpayer obtained reimbursement from her medical insurance carrier for a portion of the cost of the analysis.

Even if the psychoanalysis had not been deductible as an educational expense it could have been deductible as a medical expense if undertaken to alleviate a mental illness.

4.02 Penalty Damages

As a general rule, fines and penalties paid to the government for the violation of a statutory provision are not deductible as an ordinary and necessary business expense. In *Adolf Meller Co. v. United States*, the Court of Claims disallowed a $43,000 deduction claimed by taxpayer under section 162 as a trade or business expense. In *Meller*, the taxpayer had synthetic gemstones mailed into the country to avoid customs delays. The District Director of Customs assessed a substantial civil penalty against the taxpayer under section 592 of the Tariff Act of 1930 alleging importation of commercial shipments by means of false statements. The taxpayer paid a negotiated settlement of $43,000 and deducted it on his 1972 tax return as a section 162 business expense. The Service disallowed the deduction citing Treasury Regulation 1.162-21(b)(1)(iii). That regulation allows no deduction for amounts paid in settlement of a taxpayer's potential liability under a civil penalty. *Meller* was the first case to test the validity of Regulation 1.162-21(b)(1)(iii). The Court of Claims found the settlement to be non-deductible and thus upheld the validity of the regulation.

In contrast, the Tax Court in *Middle Atlantic Distributors, Inc. v. Commissioner* held that a penalty which is remedial in nature can be deducted as a business expense. In this case, the penalty was charged against

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27 600 F.2d 1360 (Ct. Cl. 1979).
29 72 T.C. 1136 (1979).
the taxpayer by the Customs Service as liquidated damages on a penalty against goods. The Service claimed that payment of such penalty could not be deducted because it was a compromise of potential liability. The taxpayer characterized the settlement as deductible liquidated damages. The Tax Court based its decision on the difference between compensatory and quasi-criminal penalties, finding compensatory penalties in certain cases to be deductible as business expenses. *Middle Atlantic* was distinguished from *Meller* on the grounds that although the court upheld the validity of the Treasury Regulation, the *Middle Atlantic* court only interpreted it as not applying to this particular set of facts.

4.03 Tax Shelter

Tax shelters are being closely scrutinized by the Service and those shelters which are abusive are suffering from adverse decisions in Revenue Rulings. One of the primary considerations in determining what is abusive is how the taxpayer determines the value of an asset. Where the valuation is extraordinarily high, the shelter and its depreciation or tax investment credit will come under severe attack.\(^{30}\)

A number of recent Revenue Rulings concerning tax shelters have been issued within the past year. Revenue Rulings 79-419\(^{31}\) and 80-69\(^{32}\) deal with the valuation of an asset by a taxpayer and the section 170 deduction for contributions and gifts given to or for the use of a charitable organization.

The first ruling involved a taxpayer who purchased “art” books in a foreign country at a substantial discount. He imported the “art” books, stored them for over twelve months, and then donated the books to a charitable organization. The taxpayer claimed a deduction of the retail list price of the books in the foreign country, rather than their actual cost or fair market value in this country.

The second ruling dealt with a similar fact pattern. The taxpayer held assorted gems for slightly over one year and then donated them to a charitable organization. The taxpayer claimed that the value of the gems was three times the purchase price, the value the promoter had stated the gems would be worth one year from purchase.

In making its decision in both cases the Service relied on Treasury Regulation 1-170A-1(c)(1). It first determined that where a charitable contribution consists of property, as it did in these cases, the amount of contribution is the fair market value of the property at the time of contribution. Because of the abusive nature of these transactions, the Service also relied

\(^{30}\) Estate of Franklin v. Comm’r, 544 F.2d 1045 (9th Cir. 1976).
on section 170(e)(1) which allows the Commissioner to rule that the donor's activity was sufficiently similar to the activity of a dealer selling in the ordinary course of business and the contribution would then be treated as ordinary income property which barred a deduction for any appreciation and limits any deduction to the donor's cost.\textsuperscript{33}

The taxpayer with the "art" book shelter was considered a dealer for tax purposes. Thus, in this situation, if a taxpayer proves that the fair market value exceeds his basis, his charitable contributions must be reduced by the amount of gain not recognizable as long-term capital gain. The taxpayer with the "gems" shelter was allowed to deduct only the amount that he paid for them. Under Treasury Regulation 1.170A-1(c)(2), the valuation of the item to be donated to the charitable organization must be determined from the best evidence of what the maximum fair market value would be. The taxpayer's showing was based primarily on what the promoter of the gems said their value would be. The Service felt that this was merely speculative and that the price paid was the "best" evidence of the gems' value.

A third type of "art tax shelter" has also come under close scrutiny by the Service. In Revenue Ruling 79-432\textsuperscript{34} the taxpayer purchased from an artist a lithographic plate along with a specified number of prints or the rights to make a specified number of prints from the plate. Here the taxpayer gave the artist $30,000 in cash and $170,000 in a nonrecourse note. The shelter works by attributing the entire cost to the lithographic plate and then claiming both an investment credit and depreciation on the plate.

However, the Service will not allow such treatment.\textsuperscript{35} Based on expert opinion, it was determined that the real item of value was the right to a number of limited-edition prints. From the evidence the Service determined those rights to be worth $30,000, the amount the taxpayer had paid, and that no more than $1,000 could be attributed to the plate. The taxpayer was denied both the depreciation deduction and the investment credit under several arguments made by the Service. First, since the Service does not recognize any determinable life for the value of an art object, no depreciation or investment credit can be taken.\textsuperscript{36} Second, since the plate has little if any value after the specified number of prints are made, the plate's basis is absorbed in the cost of the prints. As a result, the money expended for payment of the plate would not qualify for an investment credit. Third, the Service could determine that the taxpayer's activity was

\textsuperscript{34} 1979-2 C.B. 289.
\textsuperscript{35} See F. & D. Rentals, Inc. v. Comm'r, 44 T.C. 335 (1965).
sufficiently similar to the activity of a dealer selling prints. Therefore, these limited-edition prints would be stock-in-trade and neither depreciation nor investment credit could be taken.

Those tax shelters dealing with oil, gas, and gold have also come under close scrutiny. Particular emphasis has been placed on shelters where the deduction results in a substantial distortion of income, where nonrecourse notes are involved, or where the taxpayer's investment is not at risk, areas that three Revenue Rulings dealt with in 1980. In Revenue Ruling 80-71 a limited partnership formed to explore and develop oil and gas fields had numerous limited partners who each invested approximately $1,000 in the shelter. The general partner was a corporation whose parent was a general contractor and was responsible for the development of the wells. The tax advantage involved the allocation of the deduction for both intangible drilling and development costs to the limited partners. The problem arose for the taxpayer in that the expenses sought to be deducted were prepaid to the general partner and contractor, but the contractor had not yet begun development. Under Treasury Regulation 1.461-1(a) the Service determined that since the limited partners had no income for the year of the deduction and that the prepayment was in fact an asset having a useful life extending beyond the taxable year, these prepayments were not deductible in this tax year. If it were allowed, the transaction would not clearly reflect income as required under sections 446 and 461. The deduction can be taken in those tax years where payments are made to the general contractor in accordance with customary business practice.

Revenue Ruling 80-72 involved a taxpayer who had invested in a foreign gold mine. The promoter for the shelter arranged for the taxpayer to lease an interest in a gold reserve which included the mineral rights to the gold. The promoter would then sell an option under the taxpayer's lease on gold to be extracted, on the condition that the option could only be exercised when gold was extracted and the owner of the option could not compel extraction. The money paid for the option would be used to develop the mine. Thus, the taxpayer had no obligation to the option holder and his "at risk position" was tantamount to the situation where the taxpayer had borrowed money on a nonrecourse basis. He was "effectively protected from any true economic risk."

While the Code allows deductions for the development of a gold mine under section 616(a), the loss for any such venture is allowed only to the extent the taxpayer is at risk as defined by section 465. Here, the tax-

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89 Id.
payer could only be considered at risk for money borrowed which he was personally liable. Since this transaction was substantially similar to non-recourse financing, the taxpayer was not at risk and could only deduct amounts where the money had been expended in development, and commercially marketable quantities of gold exist.

Revenue Ruling 80-73\textsuperscript{40} deals with mineral rights tax shelters and nonrecourse financing. Here, the taxpayer entered into a lease agreement where he obtained an “operating mineral interest” in property owned by another party. As consideration the taxpayer agreed to pay by promissory note a minimum advance royalty each year for the term of the lease. The notes were “unsecured, nonrecourse, non-interest bearing, had no maturity date, and . . . payable only to the extent of the proceeds from . . . sale of minerals.”\textsuperscript{41} Taxpayer sought to deduct the amount of the advanced mineral royalties paid by the promissory note.

Under Treasury Regulation 1.612-3(b)(3) a deduction from gross income can be taken for advanced mineral royalties in the year that it is paid. However, the deduction is not allowed where the payment of royalties, as was the case here, is contingent upon whether the minerals are extracted and sold. Since the royalty payments were contingent and the giving of a nonrecourse note does not constitute payment, no deduction was allowed.

The Service has also given close scrutiny to “trust type” tax shelters. In two recent rulings the primary attack on the shelters was based on an examination of the actual substance of the transaction rather than an acceptance of the form set up by the taxpayer. In both cases the Service disallowed the trust and attributed all the sheltered income to the taxpayer.

The taxpayer in Revenue Ruling 80-74\textsuperscript{42} attended a meeting where a promoter for a tax shelter explained a “foreign tax haven double trust.” The promoter stated the double trust would “reduce or eliminate . . . income tax liabilities . . . [and] . . . provide . . . benefits such as avoidance of probate, elimination of federal estate and gift tax . . . and avoidance of various state and local taxes.”\textsuperscript{43} The promoter acting as the taxpayer’s agent would create a trust consisting of income producing property in the name of the taxpayer. The promoter-agent would then create a second trust in the foreign country naming the first trust as trustee. This second trust retains the income of the first trust and at times distributes it to the taxpayer and his family. The taxpayer continues to manage the property as he had done prior to the trust’s creation and his being named trustee.

\textsuperscript{40} 1980-11 I.R.B. 10.
\textsuperscript{41} Id.
\textsuperscript{43} Id.
Section 7701(a)(31) states that the income from a foreign trust which is not connected with a trade or business within the United States is not includable in gross income of the individual taxpayer. However, where the grantor has not given up ownership and control of the assets, as is the case here, under section 671, those “items of income, deductions, and credits” are included in the taxpayers taxable income. Neither can the taxpayer take a deduction for the costs of the trust."

The second tax shelter “trust” was ruled upon in Revenue Ruling 80-75, where several taxpayers paid money into a trust for which they would receive income and interest with any remainder passing to a designated person. The trustee was given the power to engage in business and used the sum paid into the trust to purchase a patent. The beneficiaries sought to deduct any depreciation or amortization that involved the trust property. They also attempted to avoid the “at risk of loss” limitations under section 465 concerning the depreciation."

Under Treasury Regulation 301.7701-2(a)(1) the Commissioner is given the power to determine for federal tax purposes the real substance of a trust which greatly resembles a corporation. To determine if this trust would be upheld or found to be a business association the Service looked at whether there were associates, whether there was an objective to carry on a business, and whether there was an intent to divide the gains of the venture. From the facts the Service determined that these taxpayers were associates by virtue of their contributions, the objective was to carry on a business dealing with the patent, and the associates intended to utilize the gains of the venture. This “trust” was thus classed as a “business or commercial trust” whose primary purpose was to run a business for profit. Because of this classification for federal tax purposes, the “beneficiaries” were not allowed to deduct depreciation or amortization of the property held by the association.

5.00 Tax Deductions

5.01 Investment Tax Credit

In a recent Letter Ruling the Service held that a purchase of medical equipment by a taxpayer, after it had been leased by his wholly-owned corporation for a three month trial period, did not qualify for investment credit. Under section 46(c)(1) only “new” or “used section 38 property” qualifies

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46 Id.
for the credit. In this case the property did not qualify as new property because its "original use" did not commence with the taxpayer.\footnote{See \textit{I.R.C.} § 48(b)(2).}

In the Letter Ruling the Service also held that the equipment did not qualify as used property. Property does not qualify if, after its acquisition, "it is used by (a) a person who used such property before such acquisition, or (b) a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition."\footnote{Id. § 48(c)(1).} In this case section 179(d)(2)(A) relates to section 267(b)(2) under which an individual and a corporation of which he owns more than fifty percent of the value of the outstanding stock therein are considered related. Since the taxpayer in this case owned all of the outstanding stock of his corporation, he and his corporation were considered related; thus, since the corporation had used the property for three months prior to the time when the taxpayer purchased it, it could not qualify as used property. Although property is not considered used by a person prior to acquisition, if it is used only on a casual basis, the service held that the three month trial period could not be considered casual use.

If after the trial period, taxpayer purchased new equipment other than that leased or used during the trial period, the investment credit would still be applicable. The credit rights could also be salvaged if the equipment was purchased at the outset with an option to rescind within a stated trial period. The latter option, however, might require the taxpayer to obtain financing before making the final decision to keep the new equipment.

5.02 Energy Credits

The Windfall Profit Tax Act\footnote{Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229 (1980).} has made certain important changes that liberalize the residential energy credits available. The first major step was to increase the current nonrefundable energy credit for those expenditures made in acquiring renewable energy source equipment installed in a taxpayer's principal residence.\footnote{Id. at § 202.} Under prior law\footnote{\textit{I.R.C.} § 44C.} the maximum credit available was $2,200. The present credit is forty percent of the first $10,000 of qualifying expenditures for a maximum credit of $4,000. This increased tax credit is available after December 31, 1979.

The Act also allows two or more individuals who occupy different dwelling units that are used as principal residences to apportion among the individuals the qualified expenditures.\footnote{Windfall Profit Tax Act § 201.} The expenditures are to be ap-
portioned among the individuals according to their contribution to the cost if they share the installation costs and ownership of qualified conservation property.

6.00 Depreciation

7.00 Gains and Losses

7.01 Nonrecognition—Principal Residence—Yacht

Section 1034(a) provides for the nonrecognition of gain from the sale of a principal residence if another principal residence is purchased eighteen months before or after the sale of the former. In a 1980 Letter Ruling, the Service determined that a yacht qualified as a principal residence. The Service placed great emphasis on Treasury Regulation 1.1034(c)(3)(i) which lists as principal residences, a houseboat, a house trailer, and stock held by a tenant-stockholder in a cooperative housing corporation. From this ruling it is clear that section 1034(a) does not restrict the form that a principal residence may take but, in order to qualify, it must contain facilities for cooking, sleeping, and sanitation. The Service will look to the totality of the circumstances, including the good faith of the taxpayer. Since a yacht can be lived upon comfortably and may have the same conveniences that would be found in a house, it can qualify as a principal residence.

8.00 Procedure

8.01 Attorney Fees

The Civil Rights Attorney’s Fees Awards Act of 1976 empowers courts to award reasonable attorney’s fees to a party prevailing against the United States in “any civil action or proceeding by or on behalf of the United States. The Fifth Circuit in Key Buick Comp. v. Comm. recently held that in order for an award of attorney’s fees to be appropriate, the United States must be the “moving or initiating party” in litigation. The court held that the taxpayer could recover attorney’s fees only where he is a party-defendant in the action. Unfortunately for the taxpayer who is contesting the deficiency notices, the Attorney’s Fees Awards Act may be of little help because “little, if any, consideration was given [by Congress] to the fact that the taxpayer is only rarely the defendant in judicial proceedings.” In Key Buick Co. the Fifth Circuit affirmed the Tax Court’s denial of Attorney’s fees where taxpayer successfully contested nearly the entire amount of deficiency notices totally $166,318. The court held how-

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54 Letter Ruling 8015017 (1980).
58 613 F.2d 1306 (5th Cir. 1980).
57 Id. at 1308.
never, that the Tax Court did have the power to award attorney’s fees in appropriate cases.

In Jones v. United States, an opinion released the same day as Key Buick Co., the Fifth Circuit reversed the Tax Court’s denial of attorney’s fees. In that case the Service had ruled that one of taxpayer’s tree cutters was an employee rather than a subcontractor and hence payments to said tree cutter were subject to federal unemployment and Social Security taxes. The taxpayer immediately paid the federal unemployment taxes of $54 but did not pay the Social Security (FICA) taxes because the tree cutter had already paid his own FICA and withholding taxes. The taxpayer also filed refund claims for the federal unemployment taxes in the belief that the tree cutter was in fact a subcontractor. Despite the fact that the law and the facts clearly supported taxpayer’s position regarding the FICA taxes, the Service counterclaimed for FICA and withholding taxes in the amount of $10,170. The Service later admitted that it had filed its counterclaim far in excess of the amount due as an “attention getter.”

The Fifth Circuit in Jones reversed the district court’s denial of attorney’s fees holding that by filing the counterclaim against the taxpayer, the taxpayer became a defendant with respect that part of the action. Thus consistent with Key Buick Co., an award of attorney’s fees could be appropriate. The Fifth Circuit also held that recovery of attorney’s fees did not require a showing of bad faith. Rather, there need only be a finding that the government’s action was frivolous, unreasonable, or without foundation.

8.02 Audit Workpapers

Where a corporation is required to file financial statements with the SEC, the auditing CPA’s must evaluate the sufficiency of the corporation’s reserves to cover any potential tax liability. In making this determination the auditors assess the susceptibility to attack of all tax positions taken by the corporation. The reports, known as tax accrual audit workpapers, are at all times kept in strict confidence.

The First Circuit, in a decision that could have far reaching consequences for CPA’s and their large corporate clients, upheld a trial court’s order requiring Arthur Anderson & Co. to produce the tax accrual audit workpapers in connection with an Internal Revenue Service review of one of its clients. In the case of Arthur Anderson & Co. v. United States, the American Institute of Certified Public Accounts appeared as amicus curiae

58 613 F.2d 1311 (5th Cir. 1980).
59 Id. at 1314.
60 Id.
61 80-1 U.S.T.C. (CCH) ¶ 9360 (1st Cir. 1980).
and warned the court of the "broad detrimental impact" that the availability of such workpapers to the Service would have. 62 These warnings fell upon deaf ears, as the First Circuit dismissed the appeal.

After failing to obtain a stay of enforcement on the Service's summons pending appeal, Arthur Anderson complied by producing the workpapers. Anderson's appeal on the enforcement of the summons was therefore rendered moot. Anderson's client's appeal, however, escaped mootness because that portion of the summons commanding Anderson to testify had not yet been executed. The First Circuit dismissed the client's argument of accountant-client privilege citing Couch v. United States63 where the Supreme Court noted that no federal court had ever recognized such a privilege. 64 The First Circuit refused to depart from "The general rule [in order] to apply a privilege in this case. 65

8.03 Handwriting Exemplars

The Supreme Court held in United States v. Euge66 that the Service is empowered to compel handwriting exemplars pursuant to its summons authority under section 7602.

Euge had failed to file tax returns from 1973 through 1976. Upon investigation by the Service, the agent found only two bank accounts registered in Euge's name. The agent, suspicious that Euge was concealing others, uncovered twenty more accounts which related back to Euge but were under various aliases. To determine whether the sums deposited were in fact those of Euge, the agent issued a summons requiring Euge to appear and execute handwriting exemplars of the various signatures. Euge would not comply, and the district court ordered the samples. Then the court of appeals reversed. 67

On certiorari, 68 the Supreme Court first looked to the common law power to impose evidentiary obligations. It found handwriting exemplars to be a form of evidence, "like the body itself," to be an "identifying physical characteristic subject to production". 69 As the statute gave no express authorization to compel exemplars, the Court reasoned that in the absence of an express prohibition or of substantial counterveiling congressional poli-

62 Id.
64 United States v. Arthur Anderson & Co., 80-2 U.S.T.C. (CCH) ¶ 9515 (1st Cir. 1980).
65 Id.
66 100 S. Ct. 874 (1980).
67 587 F.2d 25 (8th Cir. 1978).
cies the statute should be interpreted broadly. This was also in keeping with precedent and other Code sections.

Euge and the dissenters interpreted the wording of section 7602 to mean documents already in existence. As handwriting exemplars must be created, the statute is inapplicable. Also rejected by the Court were the contentions that handwriting exemplars are either a search or seizure subject to fourth amendment protections or testimonial evidence protected by the fifth amendment privilege against self-incrimination. Therefore, the Court held that in order to assure the effective performance by the Service of a congressionally imposed responsibility, taxpayers may no longer refuse to provide handwriting samples when under summons.70

8.04 Jury Awards

The Supreme Court in *Norfolk & W. Ry. Co. v. Liepelt*71 decided that the jury in a FELA72 case must be instructed, on request, that damage awards are not taxable. This decision will be of benefit to employers and insurance carriers as awards will not be increased by the jury by the amount of the anticipated taxes.

In 1973 a freight train fireman was killed when a locomotive collided with a loaded hopper car. The Illinois trial court refused the defendant railroad's requested jury instruction that "your award will not be subject to any income taxes, and you should not consider such taxes in fixing the amount of your awards." The appellate court affirmed73 and appeal was denied to the Illinois Supreme Court. The Supreme Court on certiorari held that (1) it was error to exclude evidence of the income taxes payable on the decedent's past and estimated future earnings, and (2) it was error for the trial judge to refuse to instruct the jury that the award of damages would not be subject to income taxation.74

The arguments by the respondent and the dissenting opinion that were rejected or distinguished by the majority opinion included: the calculation would be too speculative and too complex, gross earnings and not after-tax figures should be used in projecting the decedent's contributions, costs of litigation are equally pertinent to the determination of compensation, the net effect is a windfall to the tortfeasor, and that these instructions are governed by state law.75

The effect of taxation will now play a more significant role in determi-
ing jury awards. The scope of the decision potentially affects all awards, not just those made under FELA. If juries, upon request, must be informed of the tax consequences under section 104(a)(2) (the personal injury exclusion), the effect will be a smaller award, as the award will not be increased to reflect potential tax liability. Before the instant case, tax consequences were usually kept from the jury. But now with the door opened, both plaintiff and defendant will be requesting that their side of the tax issue be heard.

8.05 Statute of Limitations

The statute of limitations regarding the filing of tax returns applies to three general categories: 1) correct return filed — three years;\(^76\) 2) return filed which omits more than twenty-five percent of gross income—six years;\(^77\) 3) either a fraudulent return is filed or no return is filed—statute does not run.\(^78\) In Powell v. Commissioner,\(^79\) the Tenth Circuit considered whether the filing of an amended return to an originally fraudulent return, begins the general three year statute of limitations or still allows the government to assess the tax at any time.

The Tenth Circuit determined that where a taxpayer originally files a fraudulent return, the subsequent filing of an amended return begins the general three year statute of limitation.\(^80\) The Tenth Circuit followed the reasoning of an earlier Tax Court case\(^81\) which was subsequently adopted as Revenue Ruling 79-178,\(^82\) where a nonfraudulent amended return is filed, it puts the Commissioner on notice and, absent a policy to the contrary, the statute begins to run. Thus, where either a return is not filed or fraudently filed, the subsequent filing of a correct amended return starts the general three year statute of limitations.

8.06 Tainted Evidence

A tax evasion scheme pursued by the Service under the code name "Operation Tradewinds"\(^83\) resulted in several significant procedural cases, the last of which brought the taxpayer to the United States Supreme Court. In 1972, Castle Bank in the Bahamas was suspected by the Service of shielding income for United States taxpayers.\(^84\) In order to determine the names of persons using the bank, the Service, in the now famous "briefcase

\(^76\) I.R.C. § 6501(a).
\(^77\) I.R.C. § 6501(e).
\(^78\) I.R.C. § 6501(c).
\(^79\) 614 F.2d 1263 (10th Cir. 1980).
\(^80\) Id. at 1266.
\(^81\) See Bennett v. Comm'r, 30 T.C. 114 (1958).
\(^82\) 1979-1 C.B. 3.
\(^83\) The investigation was also known as Project Haven and Project Decode.
\(^84\) The suspicion arose when a drug dealer, who was also a client of the Baskes firm, deposited a check in his bank account originally drawn on the Castle Bank.
incident," employed a female detective to lure the vice-president of the bank away from his apartment while the Service photographed the contents of the briefcase. However, in so doing the agents broke off their quick-made key in the lock. This led to the related cases of *United States v. Payner,*\(^8\) *United States v. Baskes*\(^8\) and *Kanter v. Internal Revenue Service.*\(^8\)

In *Baskes*\(^8\) the Service found attorney Baskes guilty of a conspiracy scheme masterminded by Baskes to avoid paying income and gift taxes. Baskes used the Castle Bank to set up a trust for a client using untaxed money, then, in order to cover his footsteps, transferred a worthless mining claim through several corporations and partnerships, the last of which, Fantasy-Galaxie, claimed a large deduction on partnership losses for the money actually in the trust.

Baskes first contended that the attorney-client privilege between himself and the bank gave him standing to assert that the search and seizure was illegal under the fourth amendment. The district court rejected this because the privilege exists for the benefit of the client (the Castle Bank) and not the attorney. The court also held that the supervisory powers doctrine, which basically allows the court to exclude evidence tainted with the poison of illegality, was inapplicable because it would circumvent the fourth amendment standing requirements.\(^8\)

Two months later in *Kanter,*\(^9\) another partner in the Baskes firm, Kanter, sought information from the Service concerning Operation Trade-winds through the Freedom of Information Act.\(^9\) The court held that because the information was illegally obtained, the exemption for a law enforcement investigatory files did not apply and therefore the government had to produce the documents.

Jack Payner, another taxpayer whose name was obtained through the illegal search of Castle Bank customers, fought his way to the Supreme Court only to have the Service emerge victorious and apparently the stronger for it. The Supreme Court, in *Payner,*\(^9\) ruled that "the interest in deterring illegal searches does not justify the exclusion of tainted evidence at the instance of a party who is not the victim of the challenged practices."\(^9\) Evidence will not be excluded either on fourth amendment standing grounds

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\(8\) 100 S. Ct. 2439 (1980).
\(88\) 433 F. Supp. 799.
\(89\) Id.
\(90\) 433 F. Supp. 812.
\(92\) 100 S. Ct. 2439.
\(93\) Id. at 2442.
or on prayers to the supervisory powers of the court. Supervisory powers, the court said, are not as broad as "standing" and therefore this judiciary discretionary power could not be used by the court to disregard the considered limitations of the law it is charged with enforcing.94

The dissent points out that: (1) the integrity of the courts will be questioned; (2) standing will be used as a sword by the Service; and (3) the government now and in the future could affirmatively counsel agents to illegally search one individual to obtain evidence against a third party who is the government's real target.95 The dissent also points out that the only way the Service can benefit from the illegally obtained evidence is if the information is admitted against the tax evaders. Previous restraints on admitting tainted evidence had been abandoned, the dissent said, for the Service may now act with a purposely illegal intention and "a bad faith hostility to the constitutional rights,"96 and yet the evidence gathered against the third parties will still be admissible.

8.07 Tax Preparer's Negligence Penalties

The Service is proposing more penalties on preparers for negligent or intentional disregard of rules and regulations pursuant to section 6694(a) which imposes a one hundred dollar penalty for the underestimation of the tax liability. For the fiscal year ended 1979 (12 months ended September 30, 1979), the Service proposed 4474 negligence penalties and 417 willful penalties. For the first half of fiscal year 1980 which ended on March 31, 1980, the Service has already proposed 4307 negligence penalties and 1735 willful penalties. At the present rate the number of proposed penalties for fiscal year ended 1980 would more than double that of 1979.

Revenue Ruling 80-2897 involved three situations where the tax preparers, a certified public accountant, a bank trust officer who is an attorney, and a public accountant, reported the capital gain but failed to compute the minimum tax on the capital gain deduction. In each situation the one hundred dollar penalty was imposed under section 6694(a).

In the first situation the preparer was aware of the minimum tax provisions but believed that the taxpayer would have some basis in the property sold and would later file an amended return. The preparer anticipated at the time the return was filed that the basis in the property would offset any minimum tax due.

The second situation involved the failure to report the minimum tax because of an oversight by the preparer. The preparer contended that since

94 Id.
95 Id. at 2447-8.
96 Id. at 2450.
the capital gain on which the minimum tax was imposed was clearly set out in the return there was no attempt to conceal or understate the minimum tax.

In the third situation, the preparer claimed that he was not aware of the minimum tax provisions.

Section 56(a) provides for the imposition of an income tax on certain items of tax preference. Section 57(a)(9)(A) specifically treats a capital gain deduction as a tax preference item. All three preparers, however, did not compute the minimum tax.

Regulation 1.6694-1(a)(5) places the burden of proof on the preparer concerning whether he has negligently or intentionally disregarded any rule or regulation with respect to preparing a return. Furthermore, Regulation 1.6694-1(a)(1) states that a preparer is not considered to have negligently or intentionally disregarded a rule or regulation if the preparer exercises due diligence in an effort to apply the rules and regulations to the information given to the preparer to determine the taxpayer's correct liability for tax.

In the first situation, the preparer was aware of the minimum tax provisions but did not compute the minimum tax because he believed that the basis in the capital asset would offset the minimum tax. Since the preparer did compute the capital gain without any basis, his belief that the capital asset would have some basis is not supported by the facts and circumstances. Furthermore, if the preparer did not know what the basis would be there is little support that the basis in the asset would offset the minimum tax. The preparer, therefore, did not exercise due diligence and the one hundred dollar penalty was imposed.

In the second situation, the preparer was aware of the minimum tax provisions but because of an oversight failed to report the minimum tax. Section 6694(a) does not require a delinquent act in order to constitute negligence. If the preparer had exercised due care, then the minimum tax would have been apparent. Therefore, the penalty was properly imposed against the preparer.

In the third situation the preparer was not aware of the minimum tax. The minimum tax is not an unusual term and is frequently encountered by preparers. The instructions for an individual income tax return would have indicated the existence of the minimum tax. If the preparer would have made an adequate investigation he would have discovered it. Here, the preparer's ignorance of the law is no defense to the imposition of the penalty.

Preparers have complained about the proposal to increase penalties. In the instructions for Schedule D, no mention is made of the minimum
tax. However, in another part of the instructions the preparer is warned of it. Although the idea that a preparer will be liable for a bona fide mistake may be disturbing, a diligent, well informed, and conscientious preparer would probably not make these mistakes despite the fact that the instructions are not clear and well organized.

Furthermore, preparers should be aware that infractions are accumulated in the preparer's name and if a preparer accumulates a large number of them, his returns may be subject to increased scrutinization.

8.08 Taxpayer Compliance Measurement Program

When the Supreme Court recently denied certiorari in the case of Internal Revenue Service v. Long. the Court by its inaction may have paved the way for widespread tax avoidance. The Service contended that if, under the Freedom of Information Act, secret formulas used in the Taxpayer Compliance Measurement Program (TCMP) are released the Service's effectiveness would be compromised.

The TCMP is the system by which the Service selects for audit various returns which are more likely to contain an understated tax liability. The Service claims that if this information were to be released, the audit selection formula could be determined and thus alert cheating taxpayers to avoid audit signals. The effect of this would be to render the selective audit procedure ineffective.

The decision by the Ninth Circuit found that the Freedom of Information Act applies to IRS computer programs as well as to printed documents. The court went on to find that, under section 6103, information which does not identify a particular taxpayer is disclosable to the public. These factors compelled the court to find in favor of disclosure of the TCMP computer tapes. The effect of this ruling may be to provide the fraudulent taxpayer with a checklist to avoid audit, thus seriously subverting the Service's selective audit procedure. As such, it would have a devastating effect on the viability of the self-reporting tax system.

9.00 Inventory

9.01 Inventory Writedowns

Revenue Procedure 80-5 outlines the procedures which the taxpayer is required to make under the Supreme Court's decision in Thor Power Tool Co. v. Commissioner which set forth the accounting methods used

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98 596 F.2d 362 (9th Cir. 1979), cert. denied, 100 S. Ct. 1851 (1980).
100 596 F.2d at 362.
in writing down excess inventory.\textsuperscript{103} \textit{Thor} upheld sections 446 and 471 which allow the Commissioner to determine whether the method used in inventory accounting is the best accounting practice and clearly reflects the taxpayer's income.

In \textit{Thor}, the corporation did not foresee any reasonable future demand for its excess inventory and, as a result, wrote it down to "net realizable value," which was approximately scrap value. However, they did not scrap or sell the excess inventory at reduced prices. The Court held that under section 471, when a taxpayer writes down excess inventory, the value to be given that inventory should be designated at replacement cost, unless the goods are scrapped, sold, or offered for sale at a lower price. Since Thor had failed to do this, its accounting method for writing down excess inventory was not allowed.\textsuperscript{104}

Revenue Procedure 80-5 is divided into five parts, two of which are significant. In part 3.01 of the Revenue Procedure, a blanket consent is given by the Service to taxpayers allowing them to change their method of excess inventory valuation to the method prescribed by the Commissioner. The taxpayer is, in fact, required to make the changes retroactively and the changes must take place in the first taxable year ending on or after December 25, 1979.

The changes can be made either voluntarily under part 3.04(1) or involuntarily under part 3.05. In either case the taxpayer may use section 481(a) to cushion the effect of any additional tax. This section allows a net adjustment to be made and prorated over the time period the taxpayer had previously used an impermissible method. The only limitation placed on the time period for the net adjustment is that it cannot exceed ten years.

Whether the taxpayer should adopt the change either voluntarily or involuntarily depends upon the tax consequences sought. Where the net adjustment shows a substantial increase in additional taxes and the taxpayer has used the impermissible method for a number of years, it may be advantageous to adopt the method voluntarily. In this way the additional tax is spread out over a number of taxable years. Involuntary adoption should be considered where the taxpayer has net operating loss carryovers. The entire adjustment is included in the taxpayer's income for that year and the net operating loss is used to offset the increase in taxable income.

However, if the taxpayer is already using or elects to use the last-in first-out (LIFO) method for the first taxable year ending on or after December 25, 1979, the taxpayer is precluded from using the net adjustments under section 481(a) by part 3.07 of the Revenue Procedure since the


\textsuperscript{104} 439 U.S. at 534-35.
entire adjustment would be included in the year the method of accounting was changed.

Part 3.12 allows the taxpayer to estimate the taxable net adjustments where he uses the procedure under section 481(a) as required by part 3.04(2) or 3.04(3). Estimation is allowed only when the taxpayer’s books and records contain insufficient information to allow him to adequately complete the requirements of section 481(a). If estimates are used, a statement must be attached to Form 3115 (Declaration to Change Inventory Methods) certifying that the records are insufficient and the information supplied has been determined by the taxpayer using his best ability under penalty of perjury.

Part 5.00 of the Revenue Procedure sets out the application procedure to be used by the taxpayer. The original is filed with the taxpayer’s timely filed tax return or amended return. It must be filed, however, before the lapse of an extended time period as allowed under section 6081. The copy must be filed with the Commissioner at the national office. Form 3115 is also required to contain four other items of information. First, the taxpayer must state whether they are filing under part 3.04 as a voluntary change or part 3.05 as an involuntary change. Second, he must demonstrate how he computed the net “spread” adjustment under section 481(a). Third, a statement must be made concerning whether any pre-1954 Code adjustments were made. And, fourth, the taxpayer must explain what time period he used to compute the net adjustment under section 481(a) and why that time period was used.

10.00 Pension, Profit Sharing and Stock Ownership Plans

10.01 Advance Funding

A qualified pension plan must meet the requirements of minimum funding as stated in section 412. The minimum funding requirements provide for the predetermined retirement benefits that will come due in the future. The Service has no objection to one’s contributing more than is required for minimum funding. Although the amount of the employer deduction will not increase for any year in which more than the required amount is funded, it may be an attractive investment technique in times of high interest rates to a cash-rich corporation. By contributing in excess of the amount required to be funded, a corporation can invest in high yielding bonds and be able to generate tax-free income from these investments. In future years, section 404(A)(1)(D) will allow the excess funding to be earned over and deducted to the extent of the maximum amount deductible for that taxable year. The interest produced from the excess funding will be required to be applied as a contribution in succeeding

years. Since section 404 provides for the carryover of employer's contributions, the qualified status of the pension plan should not be affected.\textsuperscript{106} For example, consider a corporation required to contribute $60,000 per year to meet the minimum funding requirements of its plan. If the corporation contributes $100,000, only $60,000 will be deductible for that taxable year. The $40,000 excess contribution plus the interest received on this amount can be used in the following years and deducted to the extent of the funding requirement.

The use of this investment technique will allow a corporation to take advantage of high interest rates and the generation of tax free interest that will reduce the amount of contributions in future years. Therefore, advance funding can have the effect of lowering the overall cost of operating a qualified pension plan.

It seems that if a qualified profit sharing plan has a dual purpose of providing retirement benefits and accidental or health benefits, then the taxability of such distributions will be determined by the circumstances for the payment. For the plan to have a dual purpose it must be the employer's intent that the profit sharing plan also be an accident or health plan. This intent can be evidenced by providing 100% vesting if an employee becomes totally and permanently disabled. Thus, a plan with less than 100% vesting will not constitute a health or accident plan. Also it should be noted that this disability payment should come before the employee is eligible to retire. If the employee had been eligible to retire before his permanent disability, then the lump sum distribution may not be tax free.

10.02 Disability Payouts

A lump sum distribution from a profit sharing plan paid under a disability provision may be tax free. In *Wood v. United States*,\textsuperscript{107} a qualified profit sharing plan called for twenty-five percent vesting after five years of service and five percent each year of service thereafter. It also provided that an employee would receive the full amount of his account (100% vested) on retirement or termination due to a permanent disability. The taxpayer at the time of his permanent disability had an eighty-five percent vested right in his account and received a lump sum distribution of the full amount in his account due to his permanent disability.

The issue in *Wood* was whether the distribution to the taxpayer was excludable from gross income under section 105(c) as an amount received under an accident or health plan or taxable under section 402(a)(1) as a distribution of the taxpayer's share of earned profits. The intent of the

\textsuperscript{106} Rev. Rul. 74-467, 1974-2 C.B. 132.
\textsuperscript{107} 590 F.2d 321 (9th Cir. 1979).
employer is the major factor looked to in determining whether this profit sharing plan constituted an accident or health plan. Here the employer provided for 100% vesting due to permanent disability. The intent of the employer in providing for 100% vesting upon a permanent disability caused the court to hold that such a plan was in effect a combination profit sharing plan and accident or health plan. The payment to the taxpayer was for permanent loss of a bodily function and not taxable pursuant to section 105(c). The Service argued on appeal that only the fifteen percent non-vested portion of the distribution should be subject to section 105(c) and that the eighty-five percent vested was taxable pursuant to section 402(a)(1).

The Service's argument was not adopted since the payment was made as a result of the taxpayer's disability in accordance with the employer's accident or health plan for the permanent loss of a bodily function and thus was entirely excludable from gross income, even though the taxpayer had an eighty-five percent vested right in the account at the time of payment.

In Masterson v. United States,108 the employer had a similar profit sharing plan in which an employee had a 100% vested right after ten years of service. If an employee became permanently disabled, then he was entitled to 100% of his funds regardless of his vested right. The taxpayer had a 100% vested right prior to his disability. The taxpayer then became permanently disabled before he was eligible for retirement. The taxpayer contended that the distribution was excluded from gross income as a payment made in accordance with an accident or health plan. The Service contended that the termination of employment and not the disability causing the termination triggered the lump sum distribution. The taxpayer relied on the Wood case, which "focused on the circumstances in which the payments were made, not the source of the funds."109 Similarly, the intent of the employer was to make the distribution because of taxpayer's disability. The Service's argument that since the taxpayer had a 100% vested right to the account that it should be taxable as a lump sum distribution would lead to inequitable results since an employee disabled after a short period of service would not be required to include the lump sum distribution as income, whereas another employer who was fully vested would be required to include the lump sum distribution as income. The taxability of the payments should turn on the circumstances in which the payments were made, not when the disability occurred. Therefore, the holding in both Woods and Masterson leaves the nature and taxability of the lump sum distributions uncertain until the fund is disbursed.

10.03 Integration of Workers' Compensation Benefits

Section 401(a)(5) provides that a plan will not be discriminatory

109 Id. at 455.
merely because the contributions or benefits of or on behalf of the employees under the plan “differ because of any retirement benefits created under state or federal law.” Previous to the enactment of the Employee Retirement and Income Security Act many pension plans integrated benefits under state workers’ compensation laws with the benefits from the pension plan. Guided by section 401(a)(5), the Service in Revenue Ruling 68-243 allowed a plan to offset benefits payable under a workers’ compensation law with benefits payable under a qualified pension plan.

After the enactment of ERISA, there was no expressed statutory provision concerning the workers’ compensation offset. Section 405(a)(5) was modified because of ERISA but without any change to the relevant provisions relied on by the Service in Revenue Ruling 68-243. Furthermore, section 411(a) requires “that an employee’s right to his normal retirement benefit is nonforfeitable upon the attainment of normal retirement age.” There are several permitted exceptions to this rule contained in section 411(a)(3) but none relate to the benefits payable under workers’ compensation law.

In 1977, the Service adopted Treasury Regulation 1.411(a)-4(a) which provided that “nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced to take into account benefits which are provided under the Social Security Act or under any other Federal or State law and which are taken into account in determining plan benefits.” This regulation parallels section 401(a)(5) and Revenue Ruling 68-243 in that it allows for the offsetting of workers’ compensation benefits with benefits of the qualified pension plan. Nevertheless, various suits have attacked workers’ compensation offsets as being a forfeiture that violates section 411(a).

In Utility Workers Union v. Consumers Power Co. the district court overruled three of its previously decided cases allowing an offset of workers’ compensation benefits with benefits of a qualified pension plan. The court reasoned that since workers’ compensation was not an expressed exception under section 411(a)(3), then Congress must not have intended it to be a proper forfeiture of benefits. The court also dismissed Regulation 1.411(a)-4(a) by saying the Secretary of the Treasury does not have authority to make final interpretations of the statute. The court’s decision

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has been argued on appeal and is awaiting a decision from the Sixth Circuit.

Nevertheless, the court's decision in *Utility Workers Union* has been followed by other district courts. However the Third Circuit has reversed two district court decisions276 upholding the validity of workers' compensation offset in pension plans. To support its decision the Third Circuit looked to Regulation 1.411(a)-4(a), saying the regulation was a legislative rule which was as binding on the courts as a valid statute. The court also relied upon Revenue Ruling 68-243 and the express decision by Congress not to modify the pre-existing rules under section 401(a)(5). Furthermore, the Third Circuit looked at the legislative history of ERISA and decided that Regulation 1.411(a)-4(a) was not contrary to the provisions of ERISA as a whole.

The Third Circuit had one more obstacle to overcome before it could allow the offsetting of workers' compensation benefits with the benefits of a qualified pension plan. A New Jersey statute expressly provided that workers' compensation benefits may not be offset with that of an employee's retirement pension benefits. The Third Circuit ruled that ERISA section 514(a) preempts any and all state laws as applied to ERISA. Therefore, the New Jersey statute was not applicable to the qualified pension plans and the workers' compensation offset was allowed.

Although the Third Circuit has allowed the workers' compensation offset, Congress has before it a bill that, if enacted, would eliminate this offset. However, absent congressional change it seems as if workers' compensation offsets will be allowed with a qualified pension plan.

10.04 Limitation of Benefits Raised

When the Employee Retirement and Income Security Act of 1974 was passed, the limitation on benefits for defined benefit plans was $75,000 and the maximum contribution to a defined contribution plan was $25,000. Effective January 1, 1980, the limitation for the annual benefit under defined benefit plans is $110,625 and the maximum annual addition to defined contribution plans is $36,875. These limitations for the defined benefit (section 415(b)(1)(A)) and the defined contribution (section 415(c)(1)(A)) plans have been adjusted upward to reflect the increase in

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115 Buczynski v. General Motors Corp., 616 F.2d 1238 (3rd Cir. 1980) (reversing the Alessi and Buczynski district court decisions).


the cost of living. Determination letters are not required to conform to these new provisions.

10.05 Professional Corporation—Pension

In a 1978 decision dealing with a fact pattern arising prior to the enactment of ERISA, the Tax Court held\textsuperscript{10} that two professional corporations which formed a fifty-fifty partnership did not have to cover the partnership's employees under either of the corporations' pension plans because neither corporation controlled the partnership. For purposes of minimum participation standards the test for control is defined as greater than fifty percent interest.

The Tax Court took the same view in a case arising after the enactment of ERISA.\textsuperscript{12} There one doctor had formed a professional corporation and entered into a fifty-fifty partnership with another doctor. The professional corporation adopted a pension plan that did not cover the partnership's employees. The Service contended that this plan was not qualified under section 401 because the test from 414(b) and (c) was not the exclusive test for common control. The Tax Court disagreed and held that the pension plan was qualified because the exclusive test for determining whether employees of affiliated entities should be aggregated for purposes of anti-discrimination provisions is the common control test under section 414(b) and (c). The Tax Court followed its pre-ERISA decision in saying that for purposes of determining control, the partner must have a greater than fifty percent interest in the partnership.

Considering this to be a loophole, Congress has introduced two bills that will reverse this result, House Bill 6140 and Senate Bill 2128.\textsuperscript{121} These proposed bills would add an additional subsection to section 414. The proposed subsection would require testing of qualifications for discrimination, participation, vesting, and limits on contributions and benefits with all employees of an adjunct professional organization, and all employees of the professional organizations which are related to such adjunct professional organization, being treated as employed by a single employer. A professional organization is related to an adjunct professional organization if: 1) the professional organization regularly uses the services of the adjunct professional organization or is regularly associated with the adjunct professional organization in performing professional services for third persons; 2) one or more of the individuals performing professional services for the professional organization (or one or more of the owners of such professional organization) owns an interest in the adjunct professional organization; and, 3) twenty-five percent or more

\textsuperscript{10}Thomas Kidde, M.D., Inc., 69 T.C. 1055 (1978).
\textsuperscript{12}Lloyd M. Garland, M.D., Inc., 73 T.C. 5 (1979).
of the interests in the adjunct professional organization is owned by persons described in subparagraph (2). If this bill is enacted, the change will be effective for plan years beginning after December 31, 1979.

The proposed legislation does not upset the use of service bureau personnel to narrow the coverage of a qualified plan. This method requires the professional corporation to subscribe with an unrelated party to provide them with rented employees. However, the service bureau must in actuality perform more than a payroll service. The service bureau must have control and direction over each employee in the performance of services, manner of performance, hiring, firing, place of employment, and working hours. If the subscribing corporation has the control of the service bureau's employees, as in Edward L. Burnetta, O.D., P.A. v. Commissioner, an employer-employee relationship will exist between the professional corporation and the service bureau personnel. Therefore, these employees will be included in the minimum coverage requirements of section 401.

A recent letter ruling warns of another situation that may cause the service bureau personnel to be included as employees of the subscribing corporation. This may occur when the subscribing corporation had previously employed a person who now works for the service bureau without any definite termination of the employer-employee relationship that formerly existed with the subscribing corporation. The letter ruling also states that "a contractual arrangement is not determinative of an employer-employee relationship when the realities of the situation contradict the terms of the contract." The determination of the employer will be resolved in light of the facts and circumstances of each relationship. The length of time that one person works for any subscribing corporation may be a significant factor in determining his employer.

This letter ruling further holds that if the subscribing corporation does not have control over these rented employees, the coverage requirements of sections 401(d)(3) and 410 (b)(1) will not be applicable to them. The situation under consideration in the letter ruling was similar to the one discussed in Revenue Ruling 75-41. The service bureau recruited, tested, hired and instructed the workers involved. The service bureau had contracts with the rented employees which subscribers could not alter. These factors indicated that an employer-employee relationship existed with the service bureau and not with the subscribing corporation. Such rented employees may be excluded from the subscriber's pension or profit sharing plan.

125 1975-1 C.B. 323.
11.00 Corporations

11.01 Dividend In Kind

Section 311(a) states that the distribution of dividends in kind is generally tax free to the corporation. Because of a recent Tax Court decision, there now exist more conditions to receive such tax free treatment.

With the Tax Court decision in Bush Brothers, corporate distributors of dividends in kind who assist in the negotiation for the sale of the in kind dividends are not entitled to section 511(a) tax free treatment. The Tax Court in disallowing section 311(a) treatment referred to a line of pre-section 311 cases which had dealt with similar issues. The Tax Court looked to a Ninth Circuit decision holding that where there was a ready market for the dividend property, the resulting gain was attributed to the corporation, even though the corporation had not participated in the sale. The Tax Court also looked to one of its own 1964 decisions that imputed gain on the dividends in kind to the distributing corporation where no business purpose existed for the distribution and where the property was expected to be immediately sold.

The Bush Brothers case concerned a family-run food processing business where certain contracts for navy beans were selected for dividend distribution. When dividends in kind were declared on the beans, the dividends were assigned to bean suppliers and quickly sold. The result was that the beans never physically moved to the shareholders since the corporation had already negotiated their sale.

The Service ruled that the distribution resulted in taxable gain to the corporation. The Tax Court on review found a lack of a substantial business purpose in the distribution and characterized the transaction as being “motivated primarily by tax avoidance.” The court further found a lack of free will available to the shareholders in the disposal of the dividends as the corporation had negotiated their sale prior to declaration. The dissenting judges saw the corporation as having the right to make such distributions tax free since the shareholders would be taxed on the full value of the distribution regardless.

11.02 Liquidation—Basis Valuation

The general rule of section 334 is that a corporation that receives property in a complete liquidation of another corporation will carry over the basis of the property from the transferor. An exception to this general rule is section 334(b)(2) which allows a stepped up basis for the assets,

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127 United States v. Lynch, 192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952).
129 73 T.C. at 437.
usually equal to the purchase price of the stock, if the subsidiary is liquidated within two years pursuant to a plan and certain other requirements are met.

Prior to the enactment of section 334(b)(2), courts utilized the judicial Kimbell-Diamond doctrine. The doctrine was created to alleviate the unequal tax consequences to a corporation which purchased the assets of another corporation with the purchase price becoming the basis of the assets pursuant to section 1012, and a corporation which purchased the stock of the other corporation and then liquidated the subsidiary with the subsidiary's basis in the assets being carried over. Under the Kimbell-Diamond doctrine the purchase of stock of a corporation followed by the liquidation of the corporation acquired was viewed as a single transaction and the acquiring corporation would receive the purchase price of the stock as the basis of the assets instead of being able to carry over the basis from the subsidiary.

The question that arose after the enactment of section 334(b)(2) was whether the Kimbell-Diamond doctrine would still be applicable if a corporation did not meet the specific requirements of section 334(b)(2). In 1968, the Court of Claims held that Congress did not intend to eliminate the Kimbell-Diamond doctrine by enacting section 334(b)(2). The court's rationale was that substance should control over form and section 334(b)(2) merely gave a taxpayer an exception for obtaining the cost basis for the assets without having to show an intent to acquire the assets. The Court of Claims also felt that, since section 334(b)(2) was applicable to corporations only and not to individuals, Congress had intended the doctrine to survive as applied to corporations as well as individuals.

In 1970 and again in 1973 the Ninth Circuit held that section 334(b)(2) has eliminated the Kimbell-Diamond doctrine. Both cases involved transactions that specifically qualified under section 334(b)(2). The Fifth Circuit was faced with a case in which the transaction was not qualified under section 334(b)(2) because the stock was not acquired by purchase, but by a section 351 exchange. In this case, the acquiring corporation purchased the stock of the acquired corporation, then transferred the stock to a new subsidiary. This subsidiary then liquidated the acquired corporation. The taxpayer clearly intended this transaction to qualify under section 334(b)(2) but blundered so as to disqualify the

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130 Kimbell-Diamond Milling Co. v. Comm'r, 187 F.2d 718 (5th Cir. 1951).
131 The IRS manual lists the use of the Kimball-Diamond doctrine as "prime issue," one that it will litigate and will not usually concede or compromise.
133 Boise Cascade Corp. v. United States, 429 F.2d 426 (9th Cir. 1970).
134 Pacific Transport Co. v. Comm'r, 483 F.2d 209 (9th Cir. 1973).
135 Chrome Plate, Inc. v. District Director of Internal Revenue (In re Chrome Plate, Inc.) 614 F.2d 990 (5th Cir. 1980).
transaction. The taxpayer argued that the doctrine should apply because of its intent to qualify under section 334(b)(2) and because the substance of the transaction should control over the form.

The Fifth Circuit followed an earlier Tax Court decision holding that the Kimbell-Diamond doctrine had been abolished and the only exception to 334(b)(1) was 334(b)(2). The Fifth Circuit thought it was apparent that Congress intended to codify the Kimbell-Diamond doctrine completely within section 334(b)(2). Although the Fifth Circuit recognized that this may lead to some inequitable results where the form controls over the substance, it said that since no exceptions were acknowledged by Congress that it was bound by section 334(b)(2). Therefore, the Fifth Circuit held:

definitely and absolutely that the Kimbell-Diamond doctrine is extinct under the 1954 code regarding corporate taxpayers. The doctrine has been codified in section 334(b)(2), which is now the sole exception to the application of a carryover basis to corporations following the complete liquidation of another corporation.

11.03 Liquidation—Reorganization

The Fifth Circuit in *General Housewares Corp. v. United States* and its companion case, *Sellers v. United States*, has decided not to follow the Court of Claims decision in *FEC Liquidating Corp. v. United States* by allowing a corporation to first adopt a plan of complete liquidation under section 337 and then prior to liquidation undergo a type “C” reorganization under section 368(a). This will allow a double tax break to the corporation and shareholder not previously allowed under the only other reported case addressing the issue, *FEC*.

In General, the corporation, (Olivier) first adopted a plan for complete liquidation within twelve months. Initially this plan called for the transfer of the corporations only asset (stock in a third corporation) to the acquiring corporation, U.S.I., for shares of U.S.I. stock. This step was clearly tax free as part of a reorganization. Oliver then sold off part of the newly acquired U.S.I. stock at a profit. Olivier used this profit to satisfy its liabilities and then pursuant to plan, completed the liquidation by distributing the remaining U.S.I. stock and assets (cash) to its shareholders. The court in a break from the *FEC* precedent, determined

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137 614 F.2d at 1000.
138 Id.
139 615 F.2d 1056 (5th Cir. 1980).
140 615 F.2d 1066 (5th Cir. 1980).
141 548 F.2d 924 (Ct. Cl. 1977).
that Olivier, the liquidating corporation, was not liable for taxes on its gain from the sale of the stock acquired during the reorganization step. The court in General did, however, rule that the cash "boot" received by the shareholders at liquidation was taxable as a dividend.\footnote{144}

The Service argued, as it had argued successfully in FEC, that sections 337 and 368(a) were mutually exclusive. The corporation could not take advantage of both the provisions under the complete liquidation and reorganization where the liquidation was an essential step in the reorganization. Their contentions were based on the different purposes placed on the two sections: reorganization requires a continuity of proprietary interests while complete liquidation requires the cessation of all business.\footnote{143} Since both sections could not apply concurrently, the Service contended that the liquidating corporation should therefore be taxed on the gain from the sale of the stock acquired through reorganization.

In arriving at its decision the court distinguished the case at hand from FEC, which had not allowed the concurrent use of liquidation and reorganization provisions, on the basis of what percent of interest the former shareholders had in the reorganized corporation. While in FEC the former shareholders had a substantial share (50%), in General the former shareholders had less than a one percent interest in the reorganized corporation.\footnote{144}

Because of this small interest held and because the court determined the two sections were in fact not mutually exclusive, it allowed the concurrent use of the liquidation and "C" reorganization provisions. Thus, the corporation could not be taxed on its gain from the sale of stock during the reorganization step.

11.04 State and Local Taxes

The unitary method is a method of taxation which allows the state to take into consideration all of a corporation's divisions, departments and subsidiaries and treat them as one "unit" for taxation purposes, regardless of how the corporation itself treats them.

In Mobil Oil Corp. v. Commissioner of Taxes of Vermont\footnote{145} the Supreme Court allowed the State of Vermont to determine Mobil's net income by the use of the "unitary method." The conflict arose when Vermont included as income, amounts received by Mobil as dividends from that corporation's foreign subsidiaries and affiliates. Mobil argued that its Vermont business, which involved distribution only, had an insufficient connection with the foreign subsidiaries which produced the dividend income, and because of

\footnote{142} 615 F.2d 1056, \textit{but see} 615 F.2d at 1068 where 'boot' was held to be nontaxable.  
\footnote{143} \textit{Id.} at 1060.  
\footnote{144} \textit{Id.} at 1062.  
\footnote{145} 100 S. Ct. 1223 (1980).
that insufficient connection, Vermont should not include that income in determining Mobil's state tax liability. Mobil contended that only the state where the corporation was domiciled, in this case New York, should be allowed to tax foreign income.

The Court disagreed, stating that Vermont could include all of Mobil's foreign dividend income in determining the corporation's net income unless the corporation could show that the foreign dividends were earned by way of "activities unrelated to the sale of petroleum products in [Vermont]." Had Mobil met its burden in showing that the activities were unrelated, Vermont could not have included the foreign income in determining Mobil's net income for state tax purposes.

In June of 1980, the Court relied on its Mobil decision in deciding Exxon Corp. v. Wisconsin Dept. of Revenue. The Exxon case dealt with Wisconsin's tax law which allowed the state to use Exxon's interstate income as well as intrastate income to determine the total corporate income subject to state taxation.

Exxon's arguments were similar to those raised by Mobil. The corporation contended that its marketing of gasoline in Wisconsin was insufficiently related to the corporation's exploration and refining activities in other states and that only the intrastate income should be considered for state tax purposes.

The Court disagreed as it had done in Mobil. The justices in a unanimous decision upheld the Wisconsin law which allowed the state to take into account both in and out-of-state income in determining that which is apportionable to the state and thus taxable. The Court stated that regardless of how the corporation treats its internal departments, they are all considered part of the "unitary business" and can be looked to by a state in determining tax liability.

11.05 Type B Reorganizations

One way in which a corporation can acquire another corporation in a tax free transaction is an exchange of voting stock of the acquiring corporation for the voting stock of the acquired corporation. This type of reorganization is provided for in section 368(a)(1)(B) and is referred to as a Type B reorganization. A Type B reorganization is tax free only if the acquisition of the acquired corporation's stock is made "solely for... the voting stock" of the acquiring corporation.

In 1968, ITT wanted to acquire Hartford Fire Insurance Company. Late in 1968, ITT acquired eight percent of Hartford's stock for cash. In May,

146 Id. at 1232.
147 100 S. Ct. 2109 (1980).
1970, ITT acquired ninety-five percent of Hartford's stock for its voting preferred stock pursuant to an exchange offer. Prior to acquiring Hartford's stock in the exchange offer, ITT disposed of its eight percent interest that it had previously purchased for cash.

The Service contended that because of the eight percent interest in stock purchased for cash, the entire exchange is taxable as it did not meet the "solely for . . . the voting stock" requirement of section 368(a)(1)(B).

In Reeves\(^\text{148}\) and Pierson,\(^\text{149}\) both the Tax Court and a district court held that the prior purchase of stock would not disqualify the exchange as a Type B reorganization. The courts interpreted the Type B reorganization to require only the acquisition of "control" of the acquired corporation "solely for . . . the voting stock" of the acquiring corporation. Section 368(c) defines "control" as possessing at least eighty percent of the voting power and total stock of a corporation. Since ITT acquired over eighty percent of Hartford in exchange solely for its voting preferred stock, then it was a qualified tax free Type B reorganization. Therefore, this holding allows up to twenty per cent of the consideration to be non-stock if eighty percent of the acquired corporation is solely for the acquiring corporation's voting stock.

Because of the number of Hartford's shareholders with diverse residences, the Service appealed these decisions to the First, Third, Fourth and Ninth Circuits. In Chapman v. Commissioner\(^\text{150}\) and Heverly v. Commissioner,\(^\text{151}\) the First and Third Circuits have reversed the Tax Court and district court decisions and accepted the Service's view.

Both courts considered the legislative and judicial history of section 368(a)(1)(B). The issue was how broadly to interpret the term "acquisition" in section 368(a)(1)(B). The Service contended that the term included both the cash purchase of the stock as well as the exchange offer. The taxpayer contended only the exchange of stock was itself an acquisition which gave ITT control of Hartford solely for the exchange of ITT voting stock.

In Helvering v. Southwest Consol. Corp.\(^\text{152}\) the Supreme Court said that the word "solely leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement."\(^\text{153}\) Revenue Ruling 75-123\(^\text{154}\) states that the requirement of a Type B reorganization will not be met if eighty percent of the acquired corporation's outstanding stock is ac-

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\(^{148}\) C.E. Graham Reeves, 71 T.C. 727 (1979).


\(^{150}\) 618 F.2d 856 (1st Cir. 1980).

\(^{151}\) 621 F.2d 1227 (3rd Cir. 1980).

\(^{152}\) 315 U.S. 194 (1942).

\(^{153}\) Id. at 198.

\(^{154}\) 1975-1 C.B. 115.
quired for voting stock and the remaining twenty percent is purchased for cash.

The Third Circuit rejected the lower court's decision "that the voting stock requirement necessarily relates to the control requirement. Instead we deem the stock requirement to have been directed to preserving the continuity of interest."\textsuperscript{155} In order for the continuity of interest requirement to be effective, Congress has required that only voting stock can be exchanged in a Type B reorganization. This policy has prevailed for fifty years, and it is for the legislature to change it.

11.06 Waiver of Family Attribution Rules

In Revenue Ruling 80-26\textsuperscript{156} the Service rejected the First Circuit's ruling in \textit{Haft Trust v. Commissioner},\textsuperscript{157} that family hostility could be considered in mitigation of family attribution rules in determining whether a stock redemption will be given dividend or capital gains treatment. The First Circuit had relied on the Tax Court's holding in \textit{Estate of Squier v. Commissioner}.\textsuperscript{158} Although the Service had originally supported \textit{Estate of Squier},\textsuperscript{159} in 1978 it withdrew its acquiescence thereto and entered a non-acquiescence in its place.\textsuperscript{160}

Section 302(b)(1) provides that redemptions "not essentially equivalent to a dividend" will be treated as a sale or exchange, subject to capital gains treatment, rather than as a dividend. In \textit{Estate of Squier}, where a closely held corporation had redeemed a portion of the estate's shares, the Tax Court found a "sharp cleavage" between the executor of the estate and members of the Squier family who still owned shares in the corporation.\textsuperscript{161} Although under section 318(3)(a) the family members' shares were attributable to the estate, the court held that the estate's actual loss of control over the corporation, rather than its actual or constructive ownership of shares, was decisive in determining whether the redemption was essentially equivalent to a dividend.\textsuperscript{162}

In \textit{Haft Trust} a closely held corporation redeemed all of the shares owned by several trusts. The trusts held shares for the benefit of the children of an officer-shareholder of the corporation. The trusts were created by said shareholder's father-in-law and the redemption of the shares was

\textsuperscript{155} 621 F.2d at 1243.
\textsuperscript{156} 1980-4 I.R.B. 7.
\textsuperscript{157} 510 F.2d 43 (1st Cir. 1975).
\textsuperscript{158} 35 T.C. 950 (1961).
\textsuperscript{159} 1961-2 C.B. 5.
\textsuperscript{160} 1978-2 C.B. 4.
\textsuperscript{161} 35 T.C. at 955.
\textsuperscript{162} Id.
an outgrowth of said shareholder's bitter divorce. Under section 318 the trusts constructively owned a slightly higher interest in the corporation after the redemption than they did prior thereto.\textsuperscript{163} Citing \textit{Estate of Squier}, the First Circuit found that the attribution rules of section 318 were not the sole criteria in determining dividend equivalency under section 302 (b)(1).\textsuperscript{164} Because there had been no finding in the trial court on the issue of family discord, the case was remanded back to the Tax Court with instructions to reconsider the case in light of the fact that family discord may negate the possibility of continued control over the corporation after redemption of shares.

The Service in Revenue Ruling 80-26, as it did in the \textit{Haft Trust} case, cites the Supreme Court case of \textit{United States v. Davis}\textsuperscript{165} as support for the proposition that the attribution rules of section 318 are determinative in measuring the dividend equivalency of a redemption under section 302 (b)(1) regardless of actual loss of control resulting from family discord. The Service's interpretation of \textit{Davis} however, significantly expands upon the language therein. In \textit{Davis}, a taxpayer who caused his family owned corporation to redeem his preferred shares argued: (1) that the attribution rules of section 318 do not apply under section 302(b)(1); and, (2) that where a redemption is motivated by a bona fide business purpose it is not essentially equivalent to a dividend. The Supreme Court however, disagreed, holding that section 318 applies to all subparagraphs of section 302 including section 302(b)(1) and that business purpose is irrelevant thereunder.\textsuperscript{166} Family discord was not an issue in \textit{Davis} and was never addressed by the Court.

\textit{Davis} is in no way inconsistent with \textit{Haft Trust} or \textit{Estate of Squier}, both of which also held that the attribution rules were applicable in determining dividend equivalency under section 302(b)(1). The latter cases simply held that family discord must also be considered under that section in order to determine whether an actual loss of control of the corporation resulted from the redemption.\textsuperscript{167} \textit{Davis} did not hold that the rules of attribution are the sole criteria under section 302(b)(1). In fact, \textit{Davis} held that in order "to qualify for treatment under [section 302(b)(1)], a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."\textsuperscript{168}

The strongest support for the position taken in Revenue Ruling 80-26

\textsuperscript{163} 510 F.2d at 46.
\textsuperscript{164} Id. at 48.
\textsuperscript{166} 510 F.2d at 48; 35 T.C. at 955-56.
\textsuperscript{167} 397 U.S. at 305-06.
\textsuperscript{168} 397 U.S. at 313.
is in the legislative history of section 318 which indicates that the section is to provide "precise standards whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his family. . . ." This does not of itself however, indicate that family discord and actual loss of control or reduction of proportionate interest in the corporation should not be considered where attribution may be applicable. In spite of this however, the Service has ruled that family discord will not be considered in determining the dividend equivalency of a redemption under section 302(b)(1).

Subject to certain requirements, section 302(c)(2) allows waiver of the attribution rules of section 318 in the event of a redemption of all of the shares held by a family member in a family owned corporation. By waiving the attribution rules, distributions upon a redemption of a family member's shares can qualify for capital gains rather than dividend treatment. In Dunn v. Commissioner, the Second Circuit criticized Treasury Regulation 1.302-4(d) which strictly applied the requirements of section 302 (c)(2).

Section 302(c)(2) waives the attribution rules for the former shareholder if immediately after the redemption he: (1) owns no interest in the corporation other than that of a creditor; (2) acquires no such interest in the corporation for ten years after the redemption; and, (3) agrees to notify the Internal Revenue Service if he does acquire such an interest. Regulation 1.302-4(d) provides that, if as a result of the redemption agreement the former shareholder holds debt instruments of the corporation and pursuant to that agreement the corporation is permitted to discharge the debt in payments the amount of certainty of which depend upon the corporation's earnings, then the shareholder has retained a proprietary interest and the payments on the instruments will be considered dividends. In Dunn the taxpayer's shares in a family owned auto distributorship were redeemed in exchange for corporate notes issued by the distributorship. Because the auto maker (General Motors) with which the distributorship dealt imposed certain working capital requirements on all of its distributors, it was necessary for the taxpayer's distributorship to retain the right to postponed payment on the notes if necessary in order to maintain working capital at the required levels. Relying on Regulation 1.302-4(d) the Service asserted that the taxpayer had retained a proprietary interest in the distributorship and contended that the payments on the notes were dividends.

The Tax Court however, held that Regulation 1.302-4(d) was

170 615 F.2d 578 (2nd Cir. 1980).
intended to apply only where the redemption agreement itself was the source of the contingency upon corporate earnings of the amount of certainty of payment. The Tax Court thus found that Regulation 1.302-4(d) could not be applied where the contingency of payments was imposed by a third party rather than by the parties to the redemption agreement. The Second Circuit affirmed, agreeing that the contingency of payments upon earnings did not affect the certainty of payments under Regulation 1.302-4(d) but, rather, affected only the time of payment. Hence, though the interest retained by the taxpayer may not have been a classic creditor's interest, it was sufficiently close to qualify under section 302(c)(2) for waiver of the attribution rules.

12.00 Subchapter S Corporation

12.01 Ownership by Children

In Fundenberg v. Commissioner7 the Service challenged the validity of minor children’s substantial ownership of a Subchapter S corporation. An ophthalmologist had set up a Sub-S corporation and transferred ninety percent of the corporate stock to his six minor children. He then appointed his wife as the custodian of the shares for the children.

To determine the actual ownership the court relied on a four part test. First, did the custodial parent act in the interest of the minor children. Second, did the parents exercise control of the stock. Third, did the parents receive any economic enjoyment from the stock. Fourth, did the parents deal at arm’s length with the corporation and the children in obtaining loans and in repaying them.173

The court held that the parents were the real owners of the stock and the entire corporate income was attributed to them.174 The children failed the actual ownership test in that: the father retained complete control of the business; loans had been made to the parents without repayment agreements; and, the custodial parent had given some of the shares to a new born child, thereby substantially affecting the other children’s interests.175

13.00 Estate Planning

13.01 Basis of Property

Prior to the Tax Reform Act of 1976176 all property which had been transferred to a beneficiary as a result of the death of the owner took a

172 1980 T.C.M. (P-H) ¶ 80,113 (1980).
173 Id. at 607.
174 Id. at 608.
175 Id.
stepup in basis equal to fair market value at date of death. In the alternative the property could be valued six months after the date of death and this would become the basis to the beneficiary. The Tax Reform Act of 1976, however, substituted the concept of “carryover basis” for inherited property so that in fact the decedent’s basis would be handed over to the beneficiary. This, of course, would mean that at such time as the beneficiary disposed of appreciated property by sale, taxable income would be generated. After much objection by the bar associations, the Society of Certified Public Accountants, trust officers and the American Banking Association, Congress relented and as part of the Energy Tax Act of 1978 declared a moratorium on carryover basis. This moratorium was finalized by the Crude Oil Windfall Profit Tax Act of 1980 which eliminated carryover basis and reinstated the stepped up basis. The stepup in basis is retroactive to the estates of all decedents dying after December 31, 1976.

Under the carryover basis rule, if the basis of property in the hands of the decedent was higher than the fair market value of the property at the date of death, sale by the estate or beneficiary resulted in a taxable loss. Because of potential inequities to estates of decedents who had relied on the application of the carryover basis rule in planning their estates, the Windfall Profit Tax Act in repealing the carryover basis rule permitted the executor or the administrator of the estate of a decedent who died after December 31, 1976 and before November 7, 1978 to elect whether to use the carryover basis or the stepped up basis. This election had to be made prior to July 31, 1980 and once made it was irrevocable. Additionally, the basis of all property acquired from the decedent had to be determined by the elected basis. This election would be beneficial for property which had decreased in value at the date of death as compared with the adjusted basis in the hands of the decedent.

13.02 Disclaimers

In Letter Ruling 8015014 the Service stated that section 2518(c) does not permit a qualified disclaimer of a partial interest in property, except where the property is severable. The Service said that “severable property is property which can be separated from other property to which it is joined and which, after severance, maintains a complete and independent existence.”

The ruling was given in regards to a husband and wife (A and B) who had executed mutual wills providing that the residue of their property

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181 Id,
was to pass to the surviving spouse and if the spouse predeceased the testator, all of the real estate, household furnishings and personal effects would pass to two of their children (C and D) as trustees for A and B's five children. The residue of the surviving spouse's property would go to the five children in equal shares upon the surviving spouse's death. A died; within nine months B died, and C and D were appointed co-executors for both estates. C and D thereupon petitioned and received the local court's approval to allow B's estate to disclaim a $20,000 savings account plus $25,000 of a $37,000 savings account. As a result of the disclaimer, the money passed outright as part of the residue to A and B's children in equal shares.

The Service said that generally, a qualified disclaimer must be one that disclaims an entire interest in the property. "However, a disclaimant shall not be treated as making a disclaimer of a partial interest in property if the disclaimer relates to severable property and the disclaimant makes a qualified disclaimer with respect to a portion of these items." The $25,000 was found to be severable property and qualified. An individual would probably not be able to make a qualified disclaimer of a fractional portion of a building, for example, under this rationale, because the property would not be severable.

Section 2518(b)(4)(B) also requires that the disclaimed property pass to a person other than the one making the disclaimer. Here C and D were found not to be in violation of section 2518(b)(4)(B) where they are "not receiving an interest which they would not have received in the absence of a disclaimer." The Service also considered it important that C and D had no discretion in the distributing the property, and that C and D were acting in a fiduciary capacity.

13.03 General Power of Appointment

The Second Circuit in Alperstein v. Commissioner, has agreed with the Third and Ninth Circuits that a general power of appointment over trust property held by a decedent will cause the trust property to be included in her estate, even though she was incompetent and therefore unable to exercise the power under state law.

In Alperstein, a husband had established a testamentary trust for the benefit of his wife. The trust was to contain the maximum benefit from the marital deduction under section 2056. The wife was granted a testamentary power over the trust, with a default provision in favor of the chil-

182 Id.
183 Id.
184 613 F.2d 1213 (2nd Cir. 1979).
185 Pennsylvania Bank and Trust Co. v. United States, 597 F.2d 382 (3rd Cir. 1979).
186 Fish v. United States, 432 F.2d 1278 (9th Cir. 1970).
dren. However, for some time prior to the husband's death and until the time of her own death the wife lacked the capacity to execute a will under state law, and was thus legally incapable of exercising the power.

Under Revenue Rulings 55-518\textsuperscript{187} and 75-350,\textsuperscript{188} the husband's estate was clearly permitted to take the marital deduction even though the wife was incompetent and unable to exercise the general power. The wife's estate argued, however, that the value of the trust property is not includible in her estate because she was never able to exercise the power due to her mental condition.

The Second Circuit held that the property subject to the power was part of the wife's estate even though she was unable to exercise the power by virtue of her incompetency. The court reasoned that "the operative verb in § 2041(a)(2) is 'has'... and [the wife] 'had' a general power of appointment at the time of her death."\textsuperscript{189}

The three circuits faced with this issue have all emphasized the creation of the power and did not consider important the probability that the power would be exercised. Such reasoning conforms to the intent of the legislature in creating a unified gift and estate tax structure. To accept taxpayer's argument would allow the property to escape "estate tax at the time of the death of the donor of the power because the competency of the donee is immaterial and also at the time of the death of the donee because competency is held to be crucial."\textsuperscript{190}

**13.04 Life Insurance**

The Eighth Circuit in *Estate of Robert B. Margrave v. Commissioner*,\textsuperscript{191} affirmed a Tax Court decision\textsuperscript{192} that allows the settlor of a revocable trust a substantial degree of flexibility and control during his lifetime over the disposition of the proceeds of an insurance policy at his death without bringing the proceeds into the settlor's gross estate.

In *Margrave*, the husband created a revocable inter vivos trust, with a bank as trustee. The wife later took out a life insurance policy on her husband, naming the bank, in its capacity of trustee of the trust created by her husband, as the primary beneficiary of the policy. There was no arrangement between the husband and wife as to the disposition of the policy or its proceeds, and the wife made all the premium payments and retained the right to change the beneficiary.

\textsuperscript{187} 1955-2 C.B. 384.
\textsuperscript{188} 1975-2 C.B. 366.
\textsuperscript{189} 613 F.2d at 1215.
\textsuperscript{190} Id. at 1218.
\textsuperscript{191} 618 F.2d 34 (8th Cir. 1980).
\textsuperscript{192} 71 T.C. 13 (1978),
The Service made two unsuccessful arguments on appeal. The first was that there existed sufficient "incidents of ownership" to cause inclusion of the insurance policy in the settlor's gross estate under section 2042(2). The Eighth Circuit Court of Appeals rejected this argument upon finding that the settlor's power was subject to the absolute discretion of his wife by her ability to change the beneficiary or revoke the policy. The second argument made was that the settlor's power to modify or revoke the trust constituted a "general power of appointment" and should therefore be included in the settlor's gross estate under section 2041. The court held that although decedent-settlor did possess a general power of appointment by virtue of his ability to modify or revoke the trust, no property interest attached to the power. The settlor had only a power over an expectancy since his wife could change the beneficiary, and section 2041 will not cause a mere expectancy to be included in an estate.

This decision could give a settlor of a great deal of control over the proceeds of a life insurance policy without bringing the proceeds into his gross estate. A pitfall may arise, however, where the family relationship is not harmonious. In such a situation the beneficiary of the life insurance policy is likely to be changed leaving the trust with no assets.

13.05 Redemption

Section 303 permits a closely held corporation to redeem shares owned by a decedent's estate and avoid dividend treatment to the extent the redemption does not exceed death taxes and funeral and administration expenses. If a redemption satisfies the requirements of section 303 it is given capital gains treatment. This favorable treatment of section 303 may be lost, however, where a redemption that qualifies for capital gains treatment under another section of the code occurs within the section 303(b)(1) time limit of thirty-nine months.

Treasury Regulation 1.303-2 states that where there is more than one redemption of stock within the thirty-nine month time limit, the distributions therefrom shall be applied against the maximum amount qualified for section 303 treatment in the order that they occur. Thus, even if a redemption of an estate's shares qualified for capital gains treatment under another section of the Code (e.g., section 302(b)) such redemption would reduce the amount by which subsequent redemptions could qualify for such treatment under section 303.

In Revenue Ruling 79-401193 the Service indicated that this principle also applies to distributions in liquidations. The ruling dealt with an estate that owned controlling interests in two closely held corporations. The shares held in one corporation satisfied the fifty percent of net gross estate

value test of section 303(b)(2) and the shares owned in the other corporation were grouped together with those of the first under the same section. Death taxes and expenses amounted to $150,000. One of the corporations was completely liquidated and the resulting distribution of $100,000 qualified for capital gains treatment under section 331(c) as well as under section 303. The second corporation redeemed some of the estate's shares and distributed $150,000. The Service held that only $50,000 (the excess of the amount of the death taxes and expenses over the amount received in the liquidating distribution prior thereto) was qualified for capital gain treatment under section 303. If the shares of the two corporations had not been grouped together, the redemption in liquidation under section 331 might have been considered separately from the redemption of the second corporation's shares under section 303. The Service, however, ruled that the grouping together of the shares under section 303(b)(2) was not elective.

In order to avoid this problem in the timing of redemptions, redemptions that do not qualify for capital gains treatment under sections of the Code other than 303 should be made prior to any other distributions that will be made within the thirty-nine month time limit. Under this approach, the benefit of section 303 would not be lost by making a redemption that would reduce the amount of distributions from redemption that qualify under section 303 for capital gains treatment even though they qualify for such treatment under other sections.