FEDERAL INCOME TAX DEVELOPMENTS: 1979

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INTRODUCTION

Federal Income Tax Developments: 1979 is the seventh 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 partitioner in this field to remain current with the changes which have occurred during the year. Research of this article includes cases decided through December 1, 1979.

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: James C. Ellerhorst, William G. Frantz, Thomas Gasce, William Healey III, Linda L. Robison, Michael P. Swanson, Alan Tobin, and Lois Yoder. Special appreciation is extended to William G. Frantz and Linda L. Robison.

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1.01 Meal Allowances - Refunds

New Revenue Procedure 79-13 allows refunds to some officers who were assessed for a tax deficiency for meal allowances received between 1970 and 1976.

On November 29, 1977, in Commissioner v. Kowalski, the Supreme Court held that cash meal allowance payments received by state police officers were not excludable from gross income under section 119. The Revenue Act of 1978 barred retroactive application of that decision. Refunds are available for officers who did not utilize the meal allowance exclusion in 1977.

Now Revenue Procedure 79-13 allows refunds to officers who did not report the allowances on their tax returns in taxable years 1970 through 1976, but who were later assessed a deficiency by the IRS for the amount of the subsistence allowance. Refunds will be allowed despite the fact that the statute of limitations will have run. Claims must be filed on or before April 16, 1979. Only officers who did not include the allowance within gross income on their originally filed tax form will get the benefit of Revenue Procedure 79-13.

1.02 Scholarship

Traditionally, resident physicians and medical interns have not been allowed to exempt amounts received from hospitals or other medical centers during the residency or internship even though the work provides a valuable learning experience and is required for completion of the medical studies.

In Burstein v. United States, the taxpayer was accepted in the Residency Training Program of the Graduate School of Medicine of the University of New Mexico. He received a $300-per-month fellowship and was

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3 See Int. Rev. Code of 1954. All subsequent references to code sections are to the Internal Revenue Code of 1954 unless otherwise indicated.
5 10 I.R.B. at 27.
6 Id.
employed at a salary of $437 per month. Evidence showed that about eight hours a week were spent at lectures and other purely educational activities. Under these facts, the court found that the $300 per month was primarily for taxpayer's education and training and was therefore excludable under section 117(g)(2). Additionally, the court found that the use of the residents was a financial detriment to the hospital and that residents did not provide additional patient care.

The important differences between Burstein and prior decisions⁹ are: (1) separate payments were made as fellowship grant and as salary; (2) the hospitals had concurrent purposes of patient care and medical education, and the intent of the grant payment was educational; (3) a definite part of the resident's activities were educational and another part was both education and a service to patients; and (4) a division between the number of hours spent in education and in services to patients is possible.

1.03 Travel - Wives

The Internal Revenue Service has followed the position taken by the Supreme Court of the United States in Central Illinois Public Service Co. v. United States,¹⁰ by ruling that convention expenses incurred by an insurance company on behalf of its employee's wives are not wages for purposes of withholding under section 340(a).¹¹ Prior to Central Illinois the Service ruled in Revenue Ruling 70-85¹² that cash allowances or reimbursement for meals paid to state police troopers on regular duty were subject to withholdings. Also, in Revenue Ruling 75-279¹³ the Service maintained that amounts paid for meals eaten by railroad employees on stops which were not made to obtain substantial sleep or rest constituted wages subject to withholding. Central Illinois abrogated that position by holding that reimbursement of lunch expenses of employees on non-overnight company travel did not constitute wages subject to withholding.

Section 3401.6 defines wages as a "remuneration for services performed." Treasury Regulation 31.3401(a)-1(g)(2) requires that in order for amounts paid as reimbursement for convention expenses to be treated as nonwage items and thus not subject to section 3402 requirements, the amount must be shown to have been specifically paid "either as advances or reimbursement for traveling or other bona fide, ordinary, and necessary expenses incurred or reasonably expected to be incurred in the business of the employer." In determining whether payments will be treated as reimbursement for expenses or remuneration for services, the courts held in

Peoples Life Ins. Co. v. United States\textsuperscript{14} and Acacia Mutual Life Ins. Co. v. United States\textsuperscript{15} that the test will be to determine the interest of the employer. The employer must be able to show that the purpose of the payments was to reimburse the employee for expenses and not to reward him for performance of his work.

In response to Letter Ruling 791015, the Service has now accepted that reimbursements for expenses do not \textit{per se} constitute section 3401 wages. However, the Service has not accepted the test applied by the courts in Peoples and Acacia. Under the Internal Revenue Service test, all the facts and circumstances must be considered.

In Letter Ruling 791015, the facts revealed that wives of the insurance salesmen were encouraged and expected to attend scheduled activities with their husbands. The attendance record of a salesman's wife was a factor considered in promotion decisions because the company perceived the wives as a valuable ingredient to the salesmen's success as they often assist their husbands. Examining the purpose of the employer's practice of requiring participation by the wives together with all the facts, the Service concluded that the payments were truly for expenses incurred and not remuneration for their services.

\subsection*{1.04 Self-Employment Tax - Independent Contractors}

A new private letter ruling imposes self-employment tax on the fees paid to a retired executive who acts as an independent consultant to his former firm.\textsuperscript{16} In this private ruling, the Service states that under the facts set forth it will not follow the decision in Barrett v. Commissioner.\textsuperscript{17} In Barrett a retired employee received fees under a consulting contract with his former employer. The Tax Court found that these fees were not subject to self-employment tax because the taxpayer was not engaged in offering his services as a consultant to firms other than his former employers.

Under the current statutory test, independent contractor status may exist whenever the person for whom the services are performed does not control or retain the right to control or direct the individual who performs the services. Treating a worker as an independent contractor not only relieves the taxpayer of federal payroll taxes but it also relieves him of state payroll taxes, such as unemployment compensation insurance, and workmen's compensation insurance. A worker can also benefit from being classified as an independent contractor. Although the percentage applicable to the SECA tax is approximately one and one-half times the employees share of FICA tax, FICA is paid on full wages, whereas the SECA tax is ap-

\textsuperscript{14} 373 F.2d 924 (Ct. Cl. 1967).
\textsuperscript{15} 272 F. Supp. 188 (D. Md. 1967).
\textsuperscript{16} Letter Ruling 7912055 (1979).
Applicable only to net income from self employment. Independent contractors are treated as self-employed and payments to them are not subject to withholding.\(^\text{18}\)

Not all income earned by an independent contractor qualifies as net earnings from self-employment, which amount is used to determine self-employment tax and Keogh plan deductions. There is a peculiarity in the definition of self-employment earnings which makes it possible for a self-employed person to receive payment for services that isn't subject to either social security tax or self-employment tax, but which doesn't bar social security benefits. Congress defined the net earnings from self-employment to which the self-employment tax applies, as meaning gross income derived from any trade or business carried on by such individual. Thus, unless an independent contractor's earnings flow from a trade or business, these earnings are not subject to the self employment tax. In *Gentile v. Commissioner,*\(^\text{19}\) the court said that the key factor in determining whether a person is carrying on a trade or business is whether an individual holds one's self out to others as engaged in the selling of goods or services. Following this reasoning, the IRS in a private letter ruling\(^\text{20}\) cited *Gentile* to the effect that continuity and regularity, together with the profit motive, are not sufficient to show that an activity constitutes a trade or business for purposes of section 162, unless the taxpayer is found to be holding himself out as offering goods or services to others.

If a retired executive acts as an independent consultant to his former firm, he will be subject to self-employment tax on his earnings only if such consulting fees qualify as net earnings from self-employment. *Barrett* held that fees received by a retired employee pursuant to a consulting contract with his former employer were not subject to self-employment tax because the taxpayer was not offering his consultant services to others in addition to his former employer. However, in Letter Ruling 7912055, the IRS definitely asserted the position that the Service will not follow the *Barrett* decision. This private ruling concerned an agreement between a major shareholder of a corporation and his corporation providing for the shareholder to render consulting services to his firm upon retirement. Additionally, he agreed not to engage in any business which might directly or indirectly be competitive with the corporation. The IRS, in finding his work to be a trade or business reasoned that merely because he is performing services exclusively for one firm does not, of itself, signify that such person is not carrying on a trade or business. Such an interpretation clouds the future of the relief of self-employment tax for the retired con-

\(^{18}\) To curtail noncompliance by independent contractors, the Administration proposes that a flat rate of ten percent be withheld from payments made in the course of trade or business for services provided by an independent contractor.

\(^{19}\) 65 T.C. 1 (1975).

sultant and most certainly invites litigation in this interim period of divisiveness between the Service and the Tax Court.

1.05 State Income Tax Refunds

The IRS recently issued Revenue Ruling 79-15\(^2\) which clarifies the effect of the zero bracket amount on the portion of the state income tax refund that must be reported as income on a subsequent year's tax return.

This situation was controlled prior to 1977 by Revenue Ruling 56-447\(^2\) which has now become obsolete. Revenue Ruling 56-447 was enacted to clarify the "tax-benefit rule," which states that only when the refund results in a tax benefit to the taxpayer, must it later be reported as income when refunded.\(^3\)

The person who used the standard deduction was allowed to exclude the entire amount of refund from income as there was no tax benefit in the year the refund was received. Prior to enactment of the zero bracket amount [z.b.a.] in 1977, a taxpayer who itemized his deductions was permitted to deduct *all* of his itemized deductions from income and therefore would receive a tax benefit from any refund.

But in tax years after 1976, the z.b.a. was enacted and created a floor ($3,200 for married filing joint, $1,600 for married filing separately, and $2,200 for single taxpayers) must be subtracted from the total itemized deductions and allowed only the excess over the floor amount to be actually deducted from Adjusted Gross Income. This created a problem when the taxpayer did not have enough itemized deductions to exceed the floor without the use of the state taxes paid during the year, but later gets a refund of a portion or all of the state taxes.

Example: Taxpayer has Adjusted Gross Income of $10,000 and itemized deductions of $2,000 plus state taxes of $1,000. His z.b.a. amount for deductions of $2,000 plus state taxes of $1,000. His z.b.a. amount for a single individual is $2,200 (this amount is increased to $2,400 for tax years after 1978). Without the use of his state taxes, taxpayer would take the standard deduction and have taxable income of $10,000. But with the use of the state taxes, he would have $2,500 of itemized deductions less the $2,200 floor gives him excess itemized deductions of $300. This would leave him with taxable income of $9,700. So the tax benefit from the use of $500 of state taxes is only $300. The Internal Revenue Service allows the first $200 of refund to be excluded from income since no benefit was derived from it.

Revenue Ruling 79-15\(^4\) allows the taxpayer to take the deduction

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\(^1\) 1979-3 I.R.B. 5.
\(^2\) 1956-2 C.B. 102.
\(^3\) *Id.*
\(^4\) 1979-3 I.R.B. 5.
currently and exclude the portion of the refund which brought the total itemized deductions up to the zero bracket amount or the amount which actually resulted in a benefit.

1.06 Constructive Receipt

In Congleton v. Commissioner,25 the taxpayer received compensation under a plan whereby the board of directors of the W. T. Congleton Co., Inc. would authorize a salary amount to be paid taxpayer and deduct the amounts from the corporation's income. Using the accrual method of accounting the corporation would deduct the amounts in the taxable year in which they were authorized regardless of when they were actually paid out. The Tax Court held that the "doctrine of constructive receipt" applied.

During the years in question, taxpayer was the president and a member of the board of directors of W. T. Congleton Co., Inc. As president, he could sign checks to be drawn against corporate checking accounts with no countersignature. He would typically withdraw amounts of cash from the corporate funds sufficient to cover living expenses for the year in which the salary was authorized. He would then withdraw the balance in the following year. By reporting income under the cash receipts and disbursements method, the taxpayer would then report the amounts as income in the year received.

Under this plan, the taxpayer had been authorized to receive a salary of $62,500 in February of 1972 and $64,500 in January of 1974. Taxpayer only withdrew $2,500 of the $62,000 in 1972, withdrawing the balance of $60,000 on March 6, 1973, and he did not withdraw any of the $64,500 until March 15, 1975, enabling him to defer recognition of income for a year. The Tax Court accepted the Commissioner's view and determined that Congleton constructively received salary income of $60,000 in 1972 and $64,500 in 1974.26

In 1949 the Second Circuit decided in Hyland v. Commissioner27 that an eighty-five percent officer-stockholder did not constructively receive income merely because of his control of the corporation. A $40,000 salary had been authorized, but Hyland had taken no steps to withdraw the amounts in the year of authorization. Mere possession of the power to make the funds available did not constitute constructive receipt without any indication of an intent to exercise such power.

Treasury Regulation 1.451-2(a) abrogated that decision by determining that income is constructively received in the taxable year during which it is credited to a taxpayer's account, set apart for him, or otherwise made available so that he could have drawn upon it during the taxable year if

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26 Id. at 557.
27 175 F.2d 422 (2d Cir. 1949).
notice of the intention to withdraw had been given. Relying on Regulation 1.451-2(a) in Benes v. Commissioner,\(^{29}\) the Tax Court held that the taxpayer constructively received income for salary authorized but not received. The keys to the court's holding included the findings that taxpayer as president of Benes Co. had full power and authority, alone, to write the checks on the company's bank account and that the company had adequate cash available.\(^{29}\) In Hurty v. United States,\(^{30}\) the Court of Claims treated the taxpayer, as having constructively received income even though the accrual was not made to the taxpayer's individual account. The controlling factor was the finding that the taxpayer was in control of the corporation and therefore in a position to receive the amount whenever he wished.\(^{31}\)

In the instant case, the taxpayer was situated similarly to the taxpayers in Benes and Hurtz. He maintained effective control of the corporation and retained full powers to withdraw from the corporate accounts. The Tax Court's holding that Congleton constructively received income is consistent with recent court holdings.

The harshness of this decision can be avoided. In Revenue Ruling 75-180,\(^ {29}\) a taxpayer proved that his salary did not become an obligation of the corporation until late in the year. At that time, it was impractical to withdraw the amount. Therefore, taxpayer was not in constructive receipt of income.

Thus, it appears that the doctrine of constructive receipt will apply to an officer-stockholder if the corporation incurs the salary obligation before the end of the year which is reflected in an accrual on its books, the income is made available for the officer-stockholder to withdraw, and the overall financial condition of the corporation is such that it can make the payments.

1.07 Earned Income - Writing Bail Bonds

In Bruno v. Commissioner,\(^ {38}\) the Tax Court held that for purposes of section 1348, capital was not a material income-producing factor in taxpayer's business of writing bail bonds. The taxpayer was required to meet certain prescribed conditions before she could write bail bonds in state and municipal courts. The state required that a surety's bond must be supported by real or personal property. Local ordinances required a $15,000 deposit of cash, negotiable securities, or some combination thereof, with the director of finance to be able to write bonds before the municipal court.

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\(^{28}\) 42 T.C. 358 (1964), aff'd 335 F.2d 929.
\(^{29}\) 42 T.C. at 381.
\(^{30}\) 12 A.F.T.R. 2d 5144 (Ct. Cl. 1963).
\(^{31}\) Id. at 5153.
\(^{32}\) 1975-1 C.B. 142.
Dorothy Bruno sought to apply the maximum tax on earned income under section 1348 to the entire net profits from her bail bonding business. The Commissioner asserted that capital is a material income-producing factor in taxpayer's bail bonding business, thereby reducing the amount of available earned income that will qualify for the benefits of section 1348.

For taxable years beginning before 1977, the fifty percent rate ceiling of section 1348 applied to earned income rather than personal service income. Personal service income consists of any income that qualifies as earned income under section 911, plus amounts received as a pension or annuity which arise from an employer-employee relationship or from tax deductible contributions to a retirement plan. Personal service income includes any income which is earned income within the meaning of section 401(c)(2)(c) and section 911(b). In Bruno, the Tax Court determined that earned income for purposes of section 1348 and this case, would be controlled by section 911(b).

The amount of income from a taxpayer's trade or business in which both personal services and capital are material income-producing factors is subject to a special limitation. Such earned income is limited to “reasonable allowance as compensation for personal services rendered by the taxpayer.” For taxable years beginning before 1979, the reasonable allowance as compensation for personal services rendered by the taxpayer could not exceed thirty percent of the taxpayer's share of the net profits of such trade or business. Section 1348 has now been amended so that for taxable years beginning after December 31, 1978, “section 911(b) shall be applied without regard to the phrase, not in excess of 30 percent of his share of the net profits of such trade or business.”

In Bruno, the parties agreed that Regulation 1.1348-3(a)(3)(ii) would furnish the test to determine whether capital is a material income-producing factor in a business. The Regulation prescribes a test for determining whether capital is a material income-producing factor based upon the form of the income received and the nature of the business.

The Tax Court regarded taxpayer's capital investment as merely incidental to her bail bonding business. The income consisted principally of revenue derived from the sale of services, and the taxpayer's ability to render continuous service that she sold and from which she derives business income was primary. The taxpayer's business obligation was to produce the accused for trial and the capital used in her business was merely incidental to her professional services.\(^{34}\)

1.08 Split Dollar Life Insurance

Under a split dollar life insurance policy, the employer pays the por-

tion of the premiums equal to the increase in the cash surrender value and the employee pays the balance. When the employee (insured) dies, the employer receives an amount equal to the funds it has provided, which represents the cash surrender value and the employee's beneficiary receives the balance. The value of the insurance protection in excess of the premiums paid by the employee must then be included in the employee's income. But both the employer and the employee's beneficiary are entitled to treat their portions as tax exempt life insurance proceeds. The same income tax result follows if the transaction is cast in some other form that results in a similar benefit to the employee.

In practical effect, although the employee must pay a substantial portion of the premium in the first year or two, his share of the premium decreases rapidly and may even be eliminated after a few years. The employer gets no deduction for his premium payments under a split-dollar arrangement since the employer is directly or indirectly a beneficiary under the policy. The employee will be taxed annually only on the amount equal to the one-year term insurance cost of the declining life insurance protection to him, less any portion of the premium he pays.

In Revenue Ruling 78-420, the Internal Revenue Service considered two transactions that resulted in benefits to the employee that were held to be similar to a "split-dollar" arrangement. In the first situation, the employer paid that part of the premium that covered the increase in cash surrender value on a policy covering a retired employee. The taxpayer-employee, the son of the retired employee, had the right to name the beneficiary. The arrangement here arose from the employer-employee relationship between the taxpayer and the corporation. The arrangement was the type contemplated in Revenue Ruling 64-328, since the taxpayer received an economic benefit by not having to pay the total premium.

In the second situation, the corporation and the wife of the taxpayer entered a similar arrangement. The policy covered the taxpayer and the wife had the right to name the beneficiary. The corporation paid the portion of the premium that covered the increase in the cash surrender value. The corporation had the right to receive out of the proceeds of the policy an amount equal to the cash surrender value of the policy, or at least an amount equal to the funds it provided for premium payments. This situation is again within purview of Revenue Ruling 64-328.

1.09 Automobile Rebates

Three years ago, purchasers of new automobiles pondered whether

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36 Id.
37 Id.
they had to include as taxable income the rebates received from automobile manufacturers. Today, this question is again confronting taxpayers who have bought certain Chrysler models and are receiving rebates from Chrysler and, in some instances, the local dealer. The Service, in Revenue Ruling 76-96,\(^{39}\) stated that a rebate received from the manufacturer or dealer by a retail customer who negotiates at arm's length with a dealer on the purchase or lease of a new automobile has not received taxable income. But the Service has still refused to rule on other types of rebates, such as those received from an employer or other concern, and the Internal Revenue Service might view these as taxable income.

2.00 Deductions

2.01 Prepaid Feed Expenses

Rev. Rul. 79-229\(^{40}\) provides a new interpretation of the requirements for taking a current deduction for prepaid feed expenses which will result in stricter scrutiny of such investments. Investment-oriented groups, who are looking at livestock-feeding operations which utilize prepaid feed as a tax shelter, may not obtain a current deduction.

Revenue Ruling 75-152,\(^{41}\) which has been superseded and amplified by the current ruling, set out a three-pronged test for determining the deductibility of prepaid feed costs. The test has not been changed, but the new interpretation of the test indicates that tax shelter investors will have a more difficult time in meeting its requirements. The three requirements of the prepaid feed cost test include:

1. The feed expenditure must be a payment for the purchase of feed rather than a deposit on feed to be obtained in the future;
2. There must be a business purpose for the payment and tax avoidance is not sufficient to satisfy this test; and,
3. The deduction of feed cost in the year of the prepayment may not result in a material distortion of income.

In determining whether a material distortion of income has occurred, the Service will consider the useful life of the resulting assets during and beyond the taxable year paid, the materiality of the expenditure in relation to the taxpayer's income for the year, and the customary, legitimate business practices of the taxpayer in conducting the live-stock operations; the amount of expenditure in relation to past purchases and the timing of the expenditure as well as whether the taxes paid by the taxpayer who consistently deducts prepaid feed costs are reasonable and comparable to the taxes that would have been paid by the same taxpayer had he consistently not paid in advance.

\(^{39}\) 1976-1 C.B. 23.
\(^{41}\) 1975-1 C.B. 144.
The taxpayer is a tax shelter investor when he only has an interest in the prepaid feed and not in other assets, as distinguished from a traditional farmer who has a significant capital investment in agricultural assets in addition to the prepaid feed. The typical transaction involves the situation where the prepaid feed is pledged as security to purchase the cattle to be fed. Where this is the situation, the Service indicates that it will look carefully at the substantive purpose behind the transaction to determine whether or not the motive is based on a valid business purpose or is simply a federal income tax avoidance technique.

Finally, where a material distortion of income is shown, the Service will exercise its broad administrative authority through the timing discretion provided in sections 446(b), 451 and 461 to determine that the use of the cash or accrual method of accounting does not provide a clear reflection of income and that therefore the taxpayer may not take a deduction in the taxable year in which it was paid for feed to be consumed by livestock in later years. This revenue ruling is not designed to affect either section 447 requiring certain farming corporations to compute taxable income on the accrual method of accounting or section 464 dealing with farming syndicates.

2.02 Depreciation - Shopping Centers

A building and its structural components may either be depreciated as a unit based on a composite depreciation life or it may be depreciated separately based on the depreciation life of the building shell and each separate component. The Tax Court in University City, Inc. v. Commissioner, followed the Internal Revenue Service in its redetermination of the useful life of a shopping center building and the various components.

The taxpayer allocated the costs of construction to the various major components and gave each one a separate useful life for depreciation based on the life of its subcomponent with the shortest useful life. The Internal Revenue Service determined that most of the components costs should be allocated to the building itself, and accepted the useful life claimed for the remaining components. The taxpayer also originally claimed a forty year useful life for the building shell and has now modified it to thirty years, while the IRS determined it to be forty-five years.

The taxpayer had contended that due to economic obsolescence, the various components should have a shorter useful life on which to base depreciation. The court noted that Regulation 1.167(a)-9 allows economic obsolescence to be taken into consideration, but "it must be shown that the property in question is or will be affected by economic conditions that will result in its being abandoned at a date prior to the end of its useful life." The taxpayer failed to meet this burden and the court felt that the taxpayer's case was founded on hypothesis.

43 Id.
The Tax Court also rejected the taxpayer's attempt to modify its determination of the useful life of the building down to thirty years. The taxpayer argued that because of problems with parking, the inability to expand, and the increase in competition, the economic life of the shopping center had been reduced. The court relied upon the earlier decision of *Rimmerman v. Commissioner* to reject this argument and say that loss of economic advantage alone is not enough to support a downward adjustment in useful life.

### 3.00 Exemptions

#### 3.01 Dependency Exemptions - Medicare Benefits

The Service, having adopted the view of the Second Circuit in *Turecamo v. Commissioner*, now permits taxpayers to disregard Part A basic medicare benefits when computing the support requirement for claiming dependents. Sections 15(e) and 152(a) allow a dependency exemption to be claimed when the taxpayer has provided more than one-half of another individual's total support for the tax year.

Prior to Revenue Ruling 79-173, Revenue Ruling 70-341 was controlling in this area and required basic medicare benefits received under Part A of title XVIII of the Social Security Act, which benefits covered hospital care, to be considered as part of the potential dependent's contributions to his own support. However, similar benefits from private insurance programs and from Part B medicare benefits—which cover doctor care—were excluded from the total. The Second Circuit in *Turecamo* rejected the idea that Part A medicare benefits were distinguishable from both Part B benefits and from private insurance benefits. The Second Circuit held that all three benefit forms were to be treated similarly and not to be included in calculating the total contributions made by the dependent to his own support.

To this extent, Revenue Ruling 79-173 revokes Revenue Ruling 70-341.

#### 3.02 Retired Employees - FICA and FUTA Exemptions

The IRS has issued two recent Letter Rulings which clarify the amounts exempt from FICA and FUTA taxes based on sections 3121 and 3306. Sections 3121(a)(3) and 3306(b)(3) relieve the employee and

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44 67 T.C. 94 (1976).
45 554 F.2d 564 (2d Cir. 1977).
47 Id.
51 2 C.B. at 31.
52 Letter Rulings 7916028 (1979) and 7848051 (1978).
employer of any liability for social security taxes (FICA) or federal unemployment taxes (FUTA), respectively, by eliminating from the definition of FICA and FUTA wages, payments "made to an employee (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) on account of retirement."

Additionally, provision under these sections was made for exclusion from the definition of FICA or FUTA wages, payments (other than vacation or sick pay) made to an employee reaching a certain age if the employee does "not work for the employer in the period for which such payment is made." Section 3121(a)(9) sets the age at 62 for purposes of FICA taxes and section 3306(a)(8) sets the age at 65 for purposes of FUTA taxes. Treasury Regulations 31.3121(a)(9)-1(a)(2) and 31.3306(G)(8)-1(a) require that the employer-employee relationship must exist for the period for which any payments are made and that the employee do no work, other than being subject to call for the performance of work.

Because the IRS apparently did not interpret these provisions as exempting deferred pay arrangements providing for payments after retirement, whether individual or groups, Congress enacted section 3121(a)(13) for FICA purposes and section 3306(G)(10) for FUTA purposes. These sections exclude from the definition of wages subject to FICA any payment or series of payments made upon or after the termination of an employee's relationship because of death, retirement, or disability. However, "payments which would have been paid if the employee's employment relationship had not so terminated," that is, if the employee had not retired, died, or become disabled, will not be excluded from FICA and FUTA wages. The benefits of this exclusion from FICA and FUTA requirements are additionally limited to group plans which make provision for employees generally or for a class or classes of employees.

The IRS recently clarified its position on the application of these code sections in two private letter rulings. In Letter Ruling 7916028, a company had entered into three separate "supplemental compensation arrangements" with its chief executive officer. The first plan called for monthly installments of $400 to be paid for ten years after retirement no earlier than age 65. In exchange, the officer agreed not to compete with the company. The second and third plans provided similar monetary payments in exchange for an agreement not to compete as well as an agreement to perform advisory services if necessary.

The Internal Revenue Service determined that these payments were payments on account of retirement and were excepted from "the taxes imposed on wages" under sections 3121(a)(3) and 3306(G)(3). However,

54 See Letter Ruling 7916028 (1979) for a more detailed description of the characteristics of these plans.
the ruling expressly left open the question of whether or not amounts received under plans two and three for advisory services would be taxable as employment income.

In another private ruling, a taxpayer asked if amounts paid under a deferred compensation plan set up to benefit previous employees who had terminated employment for reasons other than death, retirement, or disability could qualify for exclusion from FICA and FUTA requirements. The Service held that amounts paid under "a deferred bonus plan to employees whose employment is terminated for any reason other than death, disability or retirement are 'wages' for purposes of FICA and the FUTA taxes."55

4.00 Deductions

4.01 Medical Expense - Weight Reduction - Stop Smoking

The IRS in two new rulings disallowed as a medical expense deduction the cost of a weight reduction program and a program to stop smoking. In Revenue Ruling 79-151,56 taxpayer participated in a weight reduction program upon the recommendation of his physician. The taxpayer did not enter the program to cure any specific ailment or disease, but to improve his appearance, general health, and sense of well being. In Revenue Ruling 79-162,57 taxpayer, at the suggestion of his physician, participated in a program to help smokers stop smoking. The taxpayer's purpose in entering the program was not to cure any specific ailment or disease, but to improve his general health and sense of well being.

The Service, in denying the deductions, relied upon Treasury Regulation 1.213-1(e)(1)(ii) which states "Deductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness." The Internal Revenue Service makes a distinction between treatment that is merely beneficial to the general health of the individual and treatment for the prevention or alleviation of a physical or mental defect or illness. Treatment for the prevention or alleviation of a physical or mental defect or illness is deductible, whereas treatment that is merely beneficial to the general health of an individual is not deductible.

The Internal Revenue Service in a private letter ruling also disallowed as a medical expense deduction the cost of a course at a treatment center that was designed to break taxpayer of his smoking habit.58 None of these rulings is intended to be a flat prohibition of deduction in all circumstances.

57 Id.
If a program is prescribed by a physician because of a specific condition, the cost may still be deductible.

The IRS in previous rulings dealing with alcohol and drug addiction appears to be more lenient in allowing these costs to be taken as medical expense deductions. The costs of transportation to meetings of Alcoholics Anonymous Club have been held to be expenses "primarily for and essential to medical care" and are deductible.\textsuperscript{59} Alcoholism treatment at a therapeutic center\textsuperscript{60} and treatment for a dependent who became addicted to narcotic drugs and entered a therapeutic center are both deductible.\textsuperscript{61} The Regulations also allow as a medical expense deduction the cost for meals and lodging while at the therapeutic center.\textsuperscript{62}

### 4.02 Medical Expense - Capital Improvements

In \textit{Haines v. Commissioner},\textsuperscript{63} the Tax Court upheld a determination by the Commissioner that the cost of a swimming pool taxpayer had built in his home was not primarily related to his medical care, and denied the deduction as a medical expense under section 213.

The petitioner's leg was seriously broken in a skiing accident and for a limited period of time his leg required therapy. Petitioner found swimming to be beneficial to his condition and, upon the recommendation of his physician, had a pool constructed so he could exercise the leg and rebuild its strength. The pool could only be used from April through October because of the weather and contained no special equipment to aid the petitioner. The pool was suitable for general use and petitioner admitted that it was used by other members of his family and staff.

Under Regulation 1.213-1(e)(1)(iii) the test for deductibility is whether the taxpayer's expenditures were incurred for the "primary purpose" of and were "related directly to" his medical care. In \textit{Haines} the Tax Court found that neither one of these requirements was satisfied by the evidence presented and denied a deduction.\textsuperscript{64}

The Seventh Circuit in \textit{Ferris v. Commissioner},\textsuperscript{65} pointed out that the costs for any capital improvements, such as a swimming pool are indirect costs, and "[A]ny costs above those necessary to produce a functionally adequate facility are not incurred for medical care."\textsuperscript{66} The Tax Court in \textit{Haines} appears to agree with the Seventh Circuit, by raising the inference

\begin{itemize}
  \item \textsuperscript{59} Rev. Rul. 63-273, 1963-2 C.B. 112.
  \item \textsuperscript{60} Rev. Rul. 73-325, 1973-2 C.B. 75.
  \item \textsuperscript{61} Rev. Rul. 72-226, 1972-1 C.B. 96.
  \item \textsuperscript{62} Treas. Reg. § 1.213-1 (e)(1)(v)(a).
  \item \textsuperscript{63} 71 T.C. No. 60, 71 Tax Ct. Rep. Dec. (P-H) ¶ 71.60 (1979).
  \item \textsuperscript{64} 71 Tax Ct. Rep. Dec. (P-H) at 362.
  \item \textsuperscript{65} 42 A.F.T.R. 2d 5674 (7th Cir. 1978).
  \item \textsuperscript{66} \textit{Id. See also}, Briner, \textit{Federal Income Tax Developments}: 1978, 12 Akron L. Rev. 177, 189 (1978).
\end{itemize}
that they may deny or limit the additional costs incurred in a capital expenditure, when the medical treatment can be obtained at a lower cost from other available sources. The Tax Court noted:

[D]uring the period special therapy for his leg was required, it could have been secured through other far less costly means; for example, the petitioner could have secured the necessary therapy at the hospital or he could have arranged to swim at a health club which was not far from his residence.67

4.03 Gift and Leaseback Arrangement

The Tax Court68 and the Eighth Circuit69 have recently adopted a criteria approach in the gift leaseback area. Such is a significant change from the overall business purpose test employed in the Fifth Circuit.70 Under the criteria approach, the only business purpose required is in connection with the leaseback and not for the gift.

When business property is sold and then simultaneously leased back to the seller to use in his business, the general rule is to allow the seller a rental deduction which qualifies as an ordinary and necessary business expense under section 162 even if the parties to the transactions are not strangers.

A dilemma develops where both parties to the transaction have common interests, such as where professional persons seek to place business property into a trust for their children. Here, the courts are split on whether a rental deduction should be allowed. The Tax Court in Mathews v. Commissioner71 listed the following critical factors for consideration:

1. whether there is a bona fide business purpose for the leaseback,
2. whether the trust is managed and controlled by an independent trustee,
3. whether the rental amounts are reasonable,
4. whether the grantor retains substantially the same amount of control over the property donated to the trust after the gift as he did before, and
5. whether the grantor possesses a disqualifying "equity" in the property as referred to in section 162(a)(3).72

Where all of the above requirements have been met, and the trust is sufficiently separate and independent from the professional person, the

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69 Quinlivan v. Comm'r, 79-1 U.S.T.C. (CCH) ¶ 9396 (8th Cir. 1979).
70 Mathews v. Comm'r, 520 F.2d 323 (5th Cir. 1975).
71 61 T.C. 12 (1973); rev'g, 520 F.2d 323 (5th Cir. 1975).
72 61 T.C. at 18.
professional is permitted to deduct the rental payments. In reversing Mathews, the Fifth Circuit employed an overall business purpose test. Under this test, a rental deduction is allowed only if the rental payment arose solely out of business necessity for any purpose. Where the sole purpose for the payment is to divide the taxpayer's income tax, the rental deduction will be disallowed.

Recently, in Lerner v. Commissioner, a different approach to the rental deduction dilemma proved successful. In this case, Dr. Lerner set up his practice as a professional corporation in which he was the sole shareholder. He also established a Clifford trust, pursuant to sections 671-678, for the benefit of his children. Dr. Lerner transferred the business property to the trust, rather than to the corporation. The corporation, in turn, then leased the business property from the trust. By involving this third independent taxing entity, the professional corporation, Dr. Lerner eliminated the problem of establishing the trust's independence from himself because here the corporation, and not Dr. Lerner personally, was the lessee. The rental payments were considered ordinary and necessary business expenses of the professional corporation and taxable as ordinary income to the beneficiaries of the trust. Since the reversionary interest lay with Dr. Lerner and not with the lessee corporation, the Tax Court held that the rental deduction was not barred under section 162(a)(3). Applying the criteria approach as set forth by the Tax Court in Mathews, the Court found that all of the requirements were met and allowed the rental deduction to the corporation.

The Eighth Circuit in Quinlivan v. United States, joined the Tax Court in rejecting the overall business purpose test and in applying the criteria approach to the use of gift-leasebacks with short-term Clifford Trusts. In Quinlivan, two attorneys owned, as tenants in common, the building which housed their law firm. Both law partners transferred their one-half interest in the building to a bank which acted as trustee for separate trusts that the attorneys had established for their children. The trustee was independent from the attorneys and their spouses, and rental income from the building was properly taxed to the beneficiaries in accordance with sections 671-678. By a written lease, the attorneys' law firm rented the premises for an initial three-year term followed by one-year renewals at reasonable rental fees. When the law firm deducted the rental payments made to the trustee, the Internal Revenue Service disallowed the deductions contending that the rentals paid were not ordinary and necessary business expenses under section 162(a) because "the obligation to pay such rentals

73 E.g., Skemp v. Comm'r, 168 F.2d 598 (7th Cir. 1948).
74 E.g., Van Zandt v. Comm'r, 341 F.2d 440 (5th Cir. 1965).
76 79-1 U.S.T.C. (CCH) at 86971.
arose out of a transaction serving no business purpose and having tax avoidance as its sole objective."

In rejecting the business purpose test, the Eighth Circuit made the following three observations:

1. Congress has specified that the business purpose test is concerned with the "continued use or possession" of the property. There is no justification for adding an inquiry into the origin of the lessor's title in applying this requirement.  

2. By following the Internal Revenue Service's approach of permitting the sale-leaseback provisions of sections 671-678 to apply only where investment property—property not used in the grantor's trade or business—is involved, would exclude a large number of "persons whose assets consist largely of business property" from obtaining "a tax benefit clearly provided by Congress." 

3. The majority view of the courts on this issue is in line with the approach taken by the Tax Court. 

Thus, while the courts are split on the issue of allowing rental deductions for sale-leaseback arrangements involving Clifford trusts, the majority view seems to be that of the Tax Court. While the Internal Revenue Service, the Fourth Circuit, and the Fifth Circuit all advocate the business purpose test, the Tax Court, along with the Third, Seventh, Eighth, and Ninth Circuits seem to favor the criterial approach.

4.04 Travel and Entertainment Expenses

The Tax Court's decision in the recent case of Burke v. Commissioner emphasizes the crucial need to make timely diary entries at or near the time of the expenditure to substantiate away-from-home travel and entertainment expenses.

Raymond C. Burke was employed as a flight engineer for Braniff Airlines which position required him to make several business trips outside the Dallas area in 1973. Braniff reimbursed Mr. Burke for a portion of his expenditures incurred while on these business trips. Mr. Burke also served as a Reserve officer in the United States Navy. His active and reserve duty required travel away from home in 1973, and the Navy re-

77 Id. at 86971.
78 Id.
79 Id. at 86973.
80 Id.
81 Perry v. United States, 520 F.2d 235 (4th Cir. 1975).
82 520 F.2d at 323.
83 Brown v. Comm'r, 180 F.2d 926 (3d Cir. 1950).
84 168 F.2d at 598.
85 79-1 U.S.T.C. (CCH) at 86971.
86 Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972).
imbursed him for his active duty travel expenses. But the Navy did not give Mr. Burke any reimbursement for his reserve duty. Mr. Burke kept a daily diary in 1973 of his travel expenses. Following section 162(a)(2) Mr. Burke sought deductions on his income tax return for the excess amount of travel expenses he incurred while on Navy and Braniff business trips for which he was never reimbursed.

While the taxpayer's travel expenses were found to be reasonable in amount and ordinary and necessary business expenses as required by Regulation 1.162-2(a), the taxpayer's diary failed to meet adequate records requirement of section 274(d) and Regulation 1.274-5(b)(2).

Regulation 1.274-5(b)(2) requires that expenditures be substantiated by records of the following elements:
1. the amount expended,
2. the time of travel,
3. the place of travel, and
4. the business purpose.

In addition, Regulation 1.274-5(c)(2) requires that the entries in the account book or diary kept by the taxpayer be recorded at or near the time of the expenditure.

In Mr. Burke's case, it was found that although his diary contained all four of the initially required elements for substantiation, his records were inadequate because "in certain instances, the place and business purpose of petitioner's travel were recorded in later years." Mr. Burke did succeed in deducting some of his expenses by using alternate methods of substantiation (such as corroboration by business flight logs, Navy active duty orders, and canceled checks and receipts). However, this amounted to only approximately half the deduction he originally sought.

Thus, the need to keep accurate, complete and timely records of business expenses incurred while away from home is essential for compliance with the Internal Revenue Service's adequate records requirement for substantiation of deductions.

4.05 Unreasonable Compensation

Section 162(a)(1) allows a taxpayer to deduct as an ordinary and necessary business expense "a reasonable allowance for salaries." For a closely held corporation, this area is one that is the frequent cause of litigation. In *Eduardo Catalano, Inc. v. Commissioner,* the Commissioner determined that the compensation paid to the sole stockholder and only em-

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88 48 T.C.M. (P-H) at 79,195.
89 Id. See also, Treas. Reg. § 1.274-5(c)(2)(iii).
ployee was unreasonable. In 1973, the corporation paid the stockholder-employee a total compensation of over $225,000 and had net income before taxes of only $525 on gross receipts of over $700,000. The Tax Court, in holding that the compensation paid was reasonable, considered the stockholder-employee's expertise, his being the only source of income, the method of computing compensation, and the corporation's financial status after payments. The Court noted that it was disturbed by the corporation's failure to pay any dividend and stated that a point in time would come when dividends would have to begin.

The Tax Court in *Rich Plan of New England, Inc. v. Commissioner,* listed several objective factors in determining the reasonable compensation of a stockholder-executive of a closely held corporation. In the stockholder-executive's favor were: (1) his qualifications and competence as an executive; (2) his efforts and experience; (3) his instrumental part in the development and growth of the corporation; and (4) his salary as a percentage of sales had remained fairly constant and had even decreased when compared to income before taxes and salaries. Factors against the stockholder-executive were: (1) he set his own salary; (2) salary was set in October when annual profits could be measured; (3) no independent evidence to support the value of his services; and (4) the corporation's failure to pay any dividends.

In 1970 the Court of Claims held that part of the compensation paid to a stockholder-executive by his closely held corporation would be considered a dividend because the corporation had distributed little or no dividends to the stockholder. Under this ruling, many closely held corporations faced the possible disallowance of some part of the compensation paid to stockholder-executives merely because of a poor dividend history. In Revenue Ruling 79-8 the Internal Revenue Service stated its position that the dividend history of a corporation is a "very significant factor" in determining the reasonableness of compensation, but the compensation would not automatically be declared a dividend solely upon a poor dividend history. "[W]here . . . compensation . . . is found to be reasonable . . . deductions for such compensation under section 162(a) will not be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock." Even a substantial minority interest in a closely held corporation by a listed corporation will not shield a bonus compensation arrangement from the scrutiny of the Internal Revenue Service. In *Kewaunee Engineering*

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93 Charles McCandless Tile Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970).
95 *Id.*
Corp. v. Commissioner. a closely held corporation had set up for its two top stockholder-executives a bonus compensation arrangement. Shortly thereafter, International Harvester Company bought a thirty-five percent interest in the corporation and agreed to the bonus. The Tax Court disallowed part of the bonus compensation because there was no free bargain as required in the regulations. There was no arm's-length agreement because at the time the bonus was set, the two stockholder-executives were in complete control of the corporation.

4.06 Fashion Clothing

In Pevsner v. Commissioner, the Tax Court recently held that where the individual’s job requires clothing that is unsuitable for private wear because it is inconsistent with the individual’s life-style, the cost of the clothing will be deductible to the taxpayer. Such decision is a rejection of the Service’s “objective test” in applying Revenue Ruling 70-474, which states that “work-related clothing can’t be deducted if it is of a type adaptable to general or continued usage . . . .” IRS previously contended that it is necessary to look at the clothing itself, and if it can be worn off the job, a deduction will be denied.

The taxpayer in Pevsner was a boutique manager. Her job required that she wear Yves St. Laurent fashions on the job as well as at job-related social functions. All the clothing was acquired at her own expense. Taxpayer contended that this exclusive wardrobe was a deductible employee expense. The Tax Court agreed. The court pointed out that Yves St. Laurent fashions may be worn by some persons for general purposes, but “[I]t certainly is not the type of apparel worn by most women generally.”

Although this case seems to represent an exception to prior decisions, the Tax Court in 1958 reached a similar result. In Yeomans v. Commissioner, the Tax Court found that the taxpayer, who was employed as fashion coordinator of General Shoe Corporation and was required to attend various meetings of style and fashion experts in the shoe manufacturing field, could deduct the cost of her fashion clothing required to be worn at such meetings and stagings of style shows. The clothing which was used in the course of her employment and in earning her salary was not suitable for personal and private wear and was not so worn by her. Therefore, the cost of such clothing was a proper deduction in computing net income for the taxable years in question. Although the Pevsner decision kindles the argument that work-related clothing can be deducted if it is not the type of apparel worn by most people generally, the cases arising after
Yeomans indicate that this type of decision will be strictly construed and simply applied to fashion clothing. It appears that the argument that a businessman’s suit which cannot be worn in conformity with his personal life-style and which may involve sports or outdoor activities will not be an allowable business deduction.

4.07 Traveling Expense

The Tax Court, in Walliser v. Commissioner\(^1\) disallowed a deduction for the cost that taxpayer incurred in going on tour groups where he sought contacts with present and potential customers. The court held that the taxpayer’s travel expenses constituted an ordinary and necessary business expense. But since the taxpayer failed to show that the travel expenses were directly related to the active conduct of his business, they were disallowed.

As a bank officer, taxpayer was primarily responsible for the marketing of permanent and interim loans. Loan production quotas were assigned and he expected annual raises if he met them. To help meet these quotas, taxpayer and his wife traveled with tours that were sponsored by corporations and attended by area builders and developers and their spouses. The taxpayer conversed with other people on the tour about the availability of loans, but no formal meetings were held and no specific business transactions were negotiated.

The court first determined that the requisite proximate relation had been shown to constitute the travel expenses as ordinary and necessary business expenses as required in section 162(a)(2). The court then considered the Service’s position that the taxpayer had failed to show that the trips were “directly related” to the active conduct of his business as required in section 274(a).

Under the objective test set forth in Regulation 1.274-2(b)(1)(ii), it is irrelevant how the taxpayer regarded the tours. These types of tours are generally considered vacation trips, and thus under the “objective test” should be classified as entertainment. The “directly related” test requires that the taxpayer show “more than a general expectation of deriving some income or business benefit from the expenditure, other than the goodwill of the person or persons entertained.”\(^2\) The latter test was not satisfied. The intent of Congress in enacting section 274(a) was to disallow expenditures which involve merely the promotion of goodwill in a social setting.

5.00 Tax Credits

5.01 Investment Tax Credit - Rehabilitation Expenditures

The Technical Amendments Act of 1979\(^3\) coordinates the invest-

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ment tax credit (ITC) with provisions for rehabilitation of older structures.

Under prior law, section 46 required noncorporate lessors of commercial real property to follow the limitations of either producing the property themselves or leasing the property for less than half its useful life, taking into account renewal options. For the first twelve months, the section 162 deductions cannot exceed fifteen percent of the rental income to obtain ITC benefits. These limitations were intended to deal with equipment leasing, but the wording of section 46(e) makes it applicable to all "property" of noncorporate lessors. In order to qualify as section 38 property and be eligible for the investment tax credit, the limitations under section 46(e) were to be met. However, in the usual course of commercial real property leasing, the tenant is obligated to pay the taxes, maintenance and insurance. The net lease is also customary, thus placing the noncorporate lessors at a disadvantage.

This Act makes the noncorporate lessor provisions inapplicable in order to qualify rehabilitation expenditures for the investment tax credit. Now, noncorporate lessors can bypass section 46 and go directly to sections 48(a) and (g) to qualify for the investment tax credit. The effect of this is to bring back a tax shelter that Congress had sought to remedy. Investors may now deal with commercial leased real property by taking depreciation and a hefty credit against their own taxes as had been done before with equipment leasing.

6.00 Depreciation

7.00 Gains and Losses

7.01 Capital Gains - Sale and Leaseback

In a recent announcement, the Internal Revenue Service acknowledged its continued reliance on Century Electric Co. v. Commissioner in the area of sale and leaseback of property. They also reaffirmed their refusal to acquiesce in Leslie Co. v. Commissioner.

Since 1959, the Service and certain courts have been engaged in a controversy concerning the sale and leaseback of property. Both adhere to their opposite viewpoints even today. The controversy involves the applicability of section 1031 to a sale of property and leaseback for a term of thirty years or more. The IRS' position is that if the leaseback is for thirty years or more, the sale and leaseback qualifies as a tax-free exchange.
of like-kind properties under section 1031 and therefore any loss on the exchange is not recognized.\textsuperscript{109}

An example of such an exchange is illustrated in the regulations, where a taxpayer, who is not a dealer in real estate, exchanges a leasehold of real property with thirty years or more. The exchange qualifies for the non-recognition provisions of section 1031 and no loss or gain will be allowed. The reasoning is that a leasehold of thirty years or more is equivalent to a fee interest.\textsuperscript{110}

In an early Eighth Circuit case,\textsuperscript{111} the court stated that since the regulation was in force for many years, and survived reenactments of the Internal Revenue Acts, it had acquired the force of law. In Century Electric, the taxpayer sold a foundry to a college and then leased back the foundry from the college for ninety-five years. The adjusted basis of the property sold was $531,000 and the market value was $250,000. The taxpayer conveyed the property to the college and received $150,000 cash and the leasehold interest for a term of ninety-five years. The Eighth Circuit held that the transaction was a non-taxable exchange, and as such the $381,000 loss on the exchange was not allowed. The court stated that the difference between the cash and adjusted basis was the cost of the leasehold interest. Taxpayer was entitled to depreciate the leasehold ($381,000) over the term of the lease.\textsuperscript{112}

The Second Circuit,\textsuperscript{113} in reversing the Tax Court, reached an opposite conclusion. This decision marked the beginning of the present controversy between the courts and the Internal Revenue Service. In Jordan Marsh the taxpayer conveyed the fee of two parcels of property, which were used for its department store, to a stranger. In return, the taxpayer received $2.3 million which was equivalent to the fair market value of the properties. Leases of the same properties for terms of thirty years and three days with options to renew were received by the taxpayer. The rent to be paid under the leases was full and normal so that the leasehold interests were of no capital value. The court held that the transaction must be classified as a sale and allowed the taxpayer to deduct the loss as ordinary.\textsuperscript{114} The court distinguished Century Electric from its decision in Jordan Marsh by stating that the cash received by the taxpayer in Century Electric was not the full equivalent of the value of the property conveyed. Also, the leaseback did not call for a rent which was fully equal to the fair rental value of the premises, whereas the leasehold interest in Century Electric had a premium

\textsuperscript{109} Treas. Reg. § 1.1031(a)-1(c).
\textsuperscript{110} Id.
\textsuperscript{111} Century Electric Co. v. Comm'r, 192 F.2d at 160.
\textsuperscript{112} Id. at 160.
\textsuperscript{113} Jordan Marsh Co. v. Comm'r, 269 F.2d 453 (2nd Cir. 1959).
\textsuperscript{114} Id. at 458.
value. The court also distinguished *Jordan Marsh* because there the taxpayer-lessee paid all taxes on the properties.\textsuperscript{115}

The main distinction between *Century Electric* and *Jordan Marsh* centers around the Congressional intent in enacting the provisions for nontaxable exchanges (section 1031 and its predecessors). The court in *Jordan Marsh* stated, "Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment."\textsuperscript{116} When the taxpayer has not really "cashed in" on the theoretical gain or closed out a losing venture, no gain or loss should be recognized. However, the court in *Century Electric* reasoned that the nonrecognition provisions were based on the difficulty of making the valuations necessary to compute gains and losses.\textsuperscript{117}

Immediately following the *Jordan Marsh* decision, the Service published Revenue Ruling 60-43,\textsuperscript{118} which stated that the IRS will not follow the decision in *Jordan Marsh*. The IRS emphasized its position by stating that a sale and leaseback under the *Jordan Marsh* circumstances constitutes a single integrated transaction under which there is an exchange of property of like kind with cash as boot.\textsuperscript{119}

The controversy was rekindled in 1975 in *Leslie Co. v. Commissioner*,\textsuperscript{120} where the taxpayer constructed a new manufacturing plant for its own use. The cost (adjusted basis) was $3.2 million, while the fair market value of the plant was $2.4 million. The taxpayer entered into an agreement with the Prudential Insurance Company to sell them the plant for $2.4 million and Prudential leased back the property to taxpayer for a term of thirty years. The taxpayer reported a loss of $800,000 from the transaction. The Commissioner, adhering to the IRS' position on sales and leasebacks, claimed there was no loss recognized because there was a section 1031 exchange of like-kind property. However, the Tax Court held that the transaction concerning the plant constituted a sale, not an exchange, and allowed the taxpayer to deduct an ordinary loss.\textsuperscript{121} The Tax Court cited Regulation 1.1002-1(b) which defined an exchange as "[a] transaction involving the reciprocal transfer of property" (as distinguished from a transfer of property for money consideration).\textsuperscript{122}

On appeal, the Third Circuit affirmed the Tax Court ruling and agreed.

\textsuperscript{115} Id. at 457.
\textsuperscript{116} Id. at 456.
\textsuperscript{117} 192 F.2d at 159.
\textsuperscript{118} 1960-1 C.B. 687.
\textsuperscript{119} Id. at 687; See also City Investing Co. v. Comm'r, 38 T.C. 1 (1962).
\textsuperscript{120} 64 T.C. 247 (1975).
\textsuperscript{121} Id. at 254.
\textsuperscript{122} Id. at 252.
with its reasoning.123 The Third Circuit examined the conflict between *Jordan Marsh* and *Century Electric* in detail, interpreting the essential difference between the two cases as their respective views of the need to value the properties involved in a sale and leaseback.124 In *Jordan Marsh*, the purpose in creating the nonrecognition provisions was the avoidance of taxing paper gains and losses. Thus, that court would value the properties involved to determine whether the requirements of an exchange have been met. In *Century Electric*, the court found the purpose of the nonrecognition provisions was to relieve the administrative burden of valuation of the properties involved. Therefore, the *Century Electric* view regards the value of the properties as irrelevant.

The Third Circuit in *Leslie*, determined the *Jordan Marsh* approach the "more satisfactory" one.125 In support, it considered the *Jordan Marsh* "exchange" definition created by the Treasury and its interpretation of Congress' purpose in making the nonrecognition provisions.

Neither the Tax Court nor the *Leslie* decision influenced the IRS' position on sale and leasebacks. The Service recently stated that the Commissioner does not acquiesce in the Leslie decision of the Tax Court.126 The Service still relies on the *Century Electric* case and Regulation 1.1031(a)-1(c) as the proper authority on sale and leaseback cases, where the leaseback is for thirty years or more. Thus, the battle, now in its twentieth year, continues with neither the courts nor the Service discarding its initial viewpoint.

### 7.02 Capital Gains - Patents

The Internal Revenue Service reversed its earlier position regarding capital gain treatment in the transfer of patents by an individual to his wholly owned corporation.127 The Service now agrees with the Tax Court and the Circuits that the sale by the holder of a patent to a related corporation is not subject to the unstated interest rule of section 483 since section 483(f)(4) does apply to such transfers. However, consistent with prior rulings, one who is not a holder under section 1235(b), does not qualify for the section 483(f)(4) exception.

Section 483 provides that where property is sold for capital gain under a deferred payment arrangement in which no interest or an inadequate rate of interest is provided, the Code will generally impute interest at seven percent compounded semi-annually, thus, converting part of the sales price into interest income. However, section 483(f)(4) states that interest will not be imputed to any deferred payments made pursuant to a transfer "described in section 1235(a) have been the subject of controversy.

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123 539 F.2d at 943.
124 *Id.* at 948.
125 *Id.* at 949.
Capital gain treatment will be given to a transfer by a holder under section 1235(b), of property consisting of all substantial rights to a patent or an unrecorded interest therein which includes a part of all such rights. Section 1235(b) defines a holder as "any individual whose efforts created such property or (2) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to the creator prior to the invention covered by the patent being put into practice." If the individual is the employer of the creator or "related" to the creator, he is not a holder. Thus, if the transfer of the substantial rights to a patent is made by an individual who does not qualify as a "holder" under section 1235(b), the transfer will not receive capital gain treatment.

Section 1235(d) provides that section 1235(a) will not apply to a transfer between related persons as determined under section 267(b) as modified by section 1235(d)(1). If the transfer of all substantial rights to a patent is made by a holder to a person who is related, under section 267(b), to the holder, the transfer will not receive capital gain treatment under section 1235(a).

The controversy of section 483(f)(4) stems from the language, "a transfer described in section 1235(a)."

The two-pronged dispute is: (1) whether a holder who transfers patent rights to a 1235(d) related person may qualify for the section 483(f)(4) exception; and (2) whether a patent owner who is not a holder under section 1235(b) may qualify for the section 483(f)(4) exception.

The Internal Revenue Service Ruling 78-124 examinated two patent transfer situations in an attempt to resolve these issues.

Situation 1: An individual transfers all substantial rights in certain patents to a corporation. The corporation is wholly owned by the individual. Payment of the purchase price is deferred over the life of the patent with no provisions made for interest. The individual is a holder under section 1235(b), but the individual and corporation are related persons within the meaning of section 1235(d). The transfer in situation one meets all the requirements of section 1235(a). It is a transfer of property consisting of all substantial rights to a patent by a holder. Therefore, it is a transfer described in section 1235(a), even though because of section 1235(d), the transfer is not governed by section 1235(a) for the purpose of determining whether the transfer is the sale of a capital asset. The Service held in Revenue Ruling 78-124 that the section 483(f)(4) exception applies to the transfer adopting a literal interpretation of the language of section 483(f)(4).

This conclusion is a complete reversal of the Service's prior position

\[128\] Id.
in Revenue Ruling 72-138. Several court decisions support the latter ruling.\textsuperscript{129}

In situation two,\textsuperscript{131} the Service looked at the issue of whether a patent owner who is not a holder under section 1235(b) may qualify for the section 483(f)(4) exception to imputed interest.

\textit{Situation 2}: A corporation transfers all substantial rights to certain patents to another unrelated corporation for a stated dollar amount. Payment of the purchase price is periodically made over the term of the transferee's use of the patent. No provision is made for the payment of interest. The transferor corporation is not a holder under section 1235(b). The Service's position in Revenue Ruling 78-124 concerning the second situation is consistent with its earlier viewpoint in Revenue Ruling 72-138. The Service concluded that the transfer is not a transfer described in section 1235(a) because the transferor is not a holder. Since the transferor is not a holder, all the requirements of section 1235(a) are not met. Since the transfer was not described in section 1235(a), the section 483(f)(4) exception is not applicable to the transfer. Interest is required to be reported according to the provisions of section 483. The Tax Court and the Court of Claims support the IRS' viewpoint in situation two.\textsuperscript{132}

The distinction between situation 1 and situation 2 and the applicability of section 483(f)(4) is fairly clear. In situation 1, the transfer was made by a \textit{holder} and all the requirements of section 1235(a) were met. The requirements of section 1235(a) were not all met in situation 2, since transferor was not a holder. Thus, the transfer in Situation 1 is literally described in section 1235(a) while the transfer in situation 2 is not. In order for a transfer to be described in section 1235(a) the transfer must meet all the requirements of section 1235. Those requirements are: the transfer must be other than by gift, inheritance or devise; there must be a transfer of property consisting of all substantial rights to a patent or an undivided interest therein which includes a part of all such rights; and, finally, that transfer must be made by a holder as defined in section 1235(b) applying a literal interpretation of section 483(f)(4) a transfer meeting all of the above requirements is a transfer described in section 1235(a). If one of the requirements is missing (such as the transferor is not a holder under section 1235(b), the transfer is not described in section 1235(a). Such a transfer would not be entitled to the section 483(f)(4) unstated interest exception.

\textsuperscript{129}1972-1 C.B. 140.


\textsuperscript{131}1978-1 C.B. at 147.

\textsuperscript{132}See Ransburg Corp. and Subsidiaries v. Comm'r, 72 T.C. 271 (1979); and, Busse v. United States, 543 F.2d 132. (Ct. Cl. 1976).
7.03 Nontaxable Charges - Like-kind Property

Two recent revenue rulings\(^{138}\) have defined a "like-kind" exchange in regards to gold coins. Although superficially inconsistent, the application of section 1030(a) is entirely consistent between the rulings and applicable court decisions. Bullion-type gold coins are one type, while numismatic (collector) coins are different. An exchange of these is not a like-kind exchange.

Certain exchanges do not produce a legally taxable exchange under section 1031(a). No gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment.

In Revenue Ruling 76-214,\(^{134}\) an exchange of Mexican fifty-peso gold coins for Austrian one-hundred-corona gold coins was held to qualify under section 1031(a) for nonrecognition of gain. The subject coins were bullion-type coins whose current value is determined on the basis of their gold content. Neither is now currency in its respective country. Thus, the Internal Revenue Service noted that the nature or character of the gold coins is the same and as such they are like-kind property under section 1031(a). Although the coins differed in size, shape, and amount, such distinctions do not relate to the nature or character of the coins. Since both coins were of bullion type, they were like-kind investment property and therefore qualified for nonrecognition of gain from the exchange under section 1031(a).

In a recent Revenue Ruling,\(^{135}\) the Internal Revenue Service sought to further clarify the "like-kind" interpretation under section 1031(a) concerning gold coins. A different result as to recognition of gain was reached in Revenue Ruling 79-143, but the application of Section 1031(a) was still consistent with Revenue Ruling 76-214.\(^{136}\) The owner of United States twenty-dollar gold coins exchanged them for South African Krugerrand gold coins. A gain was realized as a result of the exchange by the taxpayer-owner. However, this exchange was not of bullion-type coins for bullion-type coins. The United States twenty-dollar gold coins are numismatic or "collector" gold coins. The value of numismatic-type coins is determined by their age, number minted, history, art and aesthetics, condition, and metal content. The South African gold coins are bullion-type coins whose value is determined solely on the basis of their metal content. Therefore, the very nature or character of the two types of gold coins differs.

In an early, but still viable interpretation of like-kind exchanges, the

\(^{134}\) 1976-1 C.B. 218.
\(^{135}\) 19 I.R.B. at 19.
\(^{136}\) 1976-1 C.B. 218.
Fifth Circuit in Crichton\(^{137}\) held that the like-kind distinction made by the statute is broad as between classes and characters of properties, for instance, real and personal property. In Revenue Ruling 79-143,\(^{138}\) although the gold coins appeared to be similar because they both contained gold, they actually represented totally different types of underlying investments. The Internal Revenue Service stated that bullion-type coins represent an investment in gold on the world markets, while numismatic-type coins represent an investment in the coins themselves.

It should be noted that, under section 1031(a), the gain on the exchange of "like-kind" property is not immediately recognized. The basis of the property acquired is the same as the basis of the property transferred. The recognition of gain (or loss) is postponed. However, upon a sale or other taxable event concerning the property, a taxable gain will be recognized. Thus, the nontaxable exchange under section 1031 implies a tax postponement, not a tax exemption.

7.04 Nonrecognition - Three-Cornered Exchanges

The Ninth Circuit's decision in Starker v. United States,\(^{139}\) provides a liberal variation to three-cornered exchanges by permitting section 1031's nonrecognition of gain treatment to apply where the like-kind property is not exchanged simultaneously. Starker allows the buyer to credit the seller for the sales price and then to reduce this credit as the seller selects like-kind property which the buyer buys and transfers back to the seller. Any excess credit balance remaining can then be returned in cash to the seller, tax-free. And, even though the whole transaction may extend over several years, it still qualifies for nonrecognition treatment under section 1031.

When property is disposed of, the general rule, under section 1001 is that the entire gain or loss from the transaction is recognized. Section 1031 provides an exception to this general rule by deferring recognition of the gain or loss when a taxpayer makes a direct exchange of property with a second party. Section 1031 attempts to allow nonrecognition in transactions in which the nature of the investment is not changed.\(^{140}\) If "boot" is also received, gain will be recognized to the extent that the gain does not exceed the fair market value of the "boot" received.

Thus, section 1031 provides for nonrecognition of gain in three-cornered transactions where party A, rather than selling land for cash to B, transfers the land to B in exchange for B's purchase and transfer of parcel C to A. Even though the exchange does not take place until all properties are acquired, it receives nonrecognition treatment according to

\(^{137}\) Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941).
\(^{140}\) E.g., Portland Oil Co. v. Comm'r, 109 F.2d 479 (1st Cir. 1940).
And, as first established under Mercantile Trust Co. of Baltimore v. Commissioner, the possibility of A receiving cash if the C parcel cannot be obtained does not defeat the transaction's nonrecognition treatment. Several circuits have followed Mercantile Trust in holding that the mere possibility at the time of agreement that a cash sale might occur does not prevent the application of section 1031. Also, under J. H. Baird Publishing Co., it is clear that A still obtains like-kind exchange treatment even if B does not own the property to be traded at the time the exchange contract is entered into.

The recent Ninth Circuit case of Starker v. United States allows for even greater flexibility in sales transactions while retaining the benefit of nonrecognition of gains. The old method of the three-cornered transactions required delaying closing both deals until the new property could be located and the second closing could be arranged; then, a three-way closing was attempted. In practice, however, it was difficult to work out a three-way swap within the limited time restraints imposed by the closing and the escrow officers. Under the Starker case, this situation was alleviated.

In 1967, T. J. Starker, his son, and daughter-in-law entered into a Land Exchange Agreement with Crown Zellerbach Corporation in which the Starkers transferred Oregon timberland to Crown, and Crown entered an exchange balance on its books in the amount of $1.5 million for T. J. Starker and $73,500 for the Starker son and daughter-in-law. The agreement provided that the Starkers would locate acceptable parcels of real property which Crown would then purchase and convey to them, and thereupon reduce the exchange balance by the purchase price and the acquisition costs. The Starkers also received an additional credit of interest at six percent per year based on the exchange balance remaining on Crown's books at the end of each month. From 1967-1969, twelve parcels located by the Starkers were acquired by Crown and transferred to the Starkers. In 1967, three of these parcels were transferred to the son and daughter-in-law cancelling out their exchange balance, and they received no cash. Of the remaining nine parcels, two were never conveyed directly to T. J. Starker. Instead, they were transferred by Crown to Jean Roth, Starker's daughter. As to a third parcel, Crown never had title to the property itself. What Crown transferred to Starker was the purchase price plus an assignment of Crown's right to the property so that Starker could purchase it himself. The Starkers treated all the transactions as nonrecognition transactions under section 1031.

141 317 F.2d 790 (9th Cir. 1963).
142 32 B.T.A. 82 (1935).
143 Alderson v. Comm'r, 317 F.2d at 790 (9th Cir. 1963); Mercantile Trust Co. of Baltimore v. Comm'r, 320 F.2d 333 (4th Cir. 1963); and Carlton v. United States, 385 F.2d (5th Cir. 1967).
144 39 T.C. 608 (1962).
145 44 A.F.T.R. 2d at 5524.
The Internal Revenue Service disagreed, however, and assessed a tax deficiency against both T. J. Starker and the son and daughter-in-law. The younger Starkers filed an action for a tax refund and won. The court, relying on *Alderson*, held that the transfers were entitled to section 1031's nonrecognition treatment (*Starker I*). The government's appeal was voluntarily dismissed, and the Starkers received their refund.

Then, in *Starker II*, the same judge refused to apply collateral estoppel and reversed his prior holding in *Starker I*. The court narrowly interpreted the term "exchange" in section 1031 to apply only to reciprocal transfers and not for promises to convey like-kind property in the future.

On appeal to the Ninth Circuit, the two parcels that were transferred to Starker's daughter, rather than to T. J. Starker himself, were not given the benefit of nonrecognition treatment since no properties were "exchanged." To qualify as an exchange, T. J. Starker himself instead of a third party—here, his daughter—must have received the property ownership. But the court granted nonrecognition treatment to a third parcel transfer which did not pass legal title to T. J. Starker. The court held that T. J. Starker received the equivalent of a fee interest for purposes of section 1031, and that the transfers of property, to be effective, need not be made simultaneously. Also, the court held that the six percent growth factor actually represented interest to Starker. Thus, this amount was taxed to Starker as ordinary income.

The Ninth Circuit's *Starker* decision allows nonrecognition of gain treatment to apply to like-kind transfers which extend over several years. It also allows buyers to establish credit accounts for the sellers until the seller can locate appropriate like-kind property.

The Starker situation may, however, be difficult to use with all buyers. Some sellers may not want to risk leaving large, unpaid sums with certain buyers. But in an Internal Revenue Service Private Letter Ruling an alternative exists. This ruling allows the sales price to be put in trust with an independent trustee. A, according to an exchange agreement, simply transfers the property to a trust. The trust then transfers the property to B in exchange for the selling price. The trust holds the cash until A designates exchange property, C. Then the trust uses the cash to purchase the C property and transfers it to A. A can, at any time, elect to treat the transaction as a sale and get the cash. Also, any income earned on the trust corpus belongs to the trust and thus to A.

These recent decisions now permit the application of section 1031's nonrecognition treatment to reach a wider range of transfers.

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146 317 F.2d at 790.
149 Letter Ruling 7938087.
8.00 Procedure

8.01 Electronic Surveillance

In *United States v. Caceres*\(^\text{150}\) the Supreme Court held that evidence obtained by the Internal Revenue Service by use of electronic surveillance equipment in violation of an IRS regulation\(^\text{151}\) did not have to be excluded from evidence in the criminal trial of a taxpayer for bribing an Internal Revenue Service agent. The court ruled that a court has no duty to enforce agency regulations unless compliance is required by the Constitution or by statute.

Taxpayer Caceres began meeting with IRS agent Yee on March 14, 1974 concerning an audit of Carceres' 1971 personal income tax returns. At this meeting, Caceres offered Yee a "personal settlement" of $500 in exchange for a favorable resolution of the audit. On a number of subsequent occasions, recordings were made of conversations between the taxpayer and Yee. These recordings were all found to be authorized according to the regulations set out in the Internal Revenue Manual. In relevant part, the regulation states that a non-telephone conversation may be recorded with the consent of either party for a period up to thirty days if proper written authorization is received from the Attorney General. The regulation also provides for emergency approval by the Director of the Internal Security Division unless the requesting official has an excess of forty-eight hours to obtain written advance approval from the Attorney General.\(^\text{152}\)

On January 30, 1975, Yee called Caceres and arranged for a meeting the following day. On January 31, Yee acquired approval from the Director of the Internal Security Division to monitor the meeting. At the same time, Yee wrote a request to the Attorney General for authorization to record conversations for a thirty-day period. Similarly, on February 5, Yee set up a meeting with the defendant and prior to the meeting acquired emergency authorization to record the contents. This emergency request was received despite the earlier request for thirty-day authorization. Both recordings conclusively showed that Caceres had bribed Yee.

In a California district court, Caceres sought successfully to have the January 31 and February 6 recordings excluded because they were secured by emergency authorization under circumstances that allowed Yee to acquire authorization within forty-eight hours before the meeting. The Ninth Circuit upheld the suppression of the evidence, having found that the emergency did not fall within the meaning of the regulation where the emergency was a result of "government related scheduling problems."\(^\text{153}\)

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\(^{150}\) 99 S. Ct. 1465 (1979).


\(^{152}\) Id.

\(^{153}\) United States v. Caceres, 545 F.2d 1182, 1187 (9th Cir. 1976).
The Supreme Court reversed, holding that an agency rule must be designed to protect constitutional rights or be proscribed by statute before a court can require the agency to abide by it. Citing Lopez v. United States\textsuperscript{154} and United States v. White,\textsuperscript{155} the court would not allow the fourth amendment prohibiting illegal search and seizures to aid the defendant.

The Caceres decision would appear to limit the reliability of regulations provided in the Internal Revenue Service Manual. However, a close examination of the case shows that the court was reluctant to uphold a rigid rule of exclusion because of the conclusiveness of the evidence. Furthermore, the analysis applied was derived from dealing exclusively with questionable surveillance techniques.

8.02 Handwriting Samples

The Eighth Circuit\textsuperscript{156} recently held that section 7602 does not give the Internal Revenue Service authority to compel taxpayers to create handwriting samples and furnish them for comparison purposes. This decision aligns the Eighth Circuit with the Sixth Circuit\textsuperscript{157} contra to the holdings of the Fourth Circuit\textsuperscript{158} and its own prior opinion.\textsuperscript{159}

Section 7601 gives the Service a mandate to investigate persons who may be liable for taxes and section 7602 provides the authority for the IRS to conduct such investigations. Section 7602(2) gives the Secretary authorization to "summon the person liable for tax . . . to appear before the Secretary . . . and to produce such books, papers, records, or other data . . . as may be relevant or material" to the IRS investigation. The question has arisen whether section 7602 authorizes the Service to require a taxpayer whose potential tax liabilities are under investigation to appear before the IRS and furnish handwriting samples to the IRS for comparison purposes. The Circuit Courts lack uniformity in their decisions on this issue.

In United States v. Brown,\textsuperscript{160} the Sixth Circuit held that section 7602 does not authorize the Internal Revenue Service to compel the production of handwriting samples that aren't already in existence at the time of the issuance of the summons. In Brown, the Internal Revenue Service received information that the purported signature of Brown's wife on a joint return was a forgery. The Internal Revenue Service summoned Brown to give handwriting samples of his wife's signature, but Brown refused. Where a taxpayer fails or refuses to obey an administrative subpoena issued by an

\begin{itemize}
  \item \textsuperscript{154} 373 U.S. 427 (1963).
  \item \textsuperscript{155} 401 U.S. 745 (1971).
  \item \textsuperscript{156} United States v. Euge, 587 F.2d (8th Cir. 1978).
  \item \textsuperscript{157} United States v. Brown, 536 F.2d 117 (6th Cir. 1970).
  \item \textsuperscript{158} United States v. Robinsky, 547 F.2d 249 (4th Cir. 1972).
  \item \textsuperscript{159} United States v. Campbell, 524 F.2d 604 (8th Cir. 1975).
  \item \textsuperscript{160} 536 F.2d at 122.
\end{itemize}
agent of the IRS. Section 7604 allows the subpoena to be enforced by a judicial proceeding in the appropriate district court. The Sixth Circuit considered the context of section 7602 as a whole and then determined that the Service could not compel Brown to produce the handwriting samples. “Other data,” as used in section 7602(2), should be construed to include only papers, writings, or records already in existence. The Sixth Circuit stated that Congress could easily have added the words “other data of whatever kind necessary whether in existence or not,” had it wanted to authorize the Service to compel the production of handwriting samples not in existence at the time of the summons.161

A contra view is taken by the Fourth Circuit. In *United States v. Rosinsky,*162 the court held that the Internal Revenue Service did have the power under section 7602, to compel a taxpayer to produce handwriting samples for the IRS. Although not expressly allowed in section 7602, the court held that the authority given to require a taxpayer to appear impliedly carries with it the power to require certain nontestimonial acts on the part of the taxpayer-witness such as providing voice or handwriting samples.163 The court analogized the administrative summons under section 7602 to a grand jury in supporting its conclusion. Under a grand jury subpoena, a witness may be compelled to give handwriting samples and such compulsion does not violate the fourth or fifth amendments or any common law right of privacy.164

In 1975, a divided Eighth Circuit, issued an opinion stating that the Internal Revenue Service can compel handwriting samples of taxpayers under section 7602.164 The *Campbell* court held that the authority to summon “other data” in section 7602(2) includes the authority to require the taxpayer to give samples of his handwriting.165 The Internal Revenue Service’s position was that when Congress used the broad phrase “other data” it intended to empower the taxing authorities to summon any otherwise permissible material required by them to carry out their investigation and this includes handwriting samples.166 The Eighth Circuit agreed and added that the power of the Internal Revenue Service to investigate records and affairs of taxpayers should be liberally construed.

In *Euge,*167 an en banc court overruled *Campbell* and adopted the dissenting view of Justice Heaney. The *Euge* court held that the Internal Revenue Service does not have the authority to compel a taxpayer to create handwriting samples and furnish them to the Internal Revenue Service for com-

161 Id. at 122.
162 547 F.2d at 249.
163 Id. at 252.
164 524 F.2d at 604.
165 Id. at 607.
166 Id. at 606.
167 587 F.2d at 25.
parison purposes under section 7602. Pursuant to a tax investigation, Euge was served a subpoena commanding him to appear and furnish his handwriting samples. After careful consideration, the Eighth Circuit followed the rationale of Justice Heaney's dissent in *Campbell*. The court stated that compelling a person to execute a handwriting sample is a search and seizure within the meaning of the fourth amendment and that the investigatory powers of the Internal Revenue Service are clearly subordinate. Heaney also attacked the grand jury analogy as a basis for allowing compulsion of handwriting samples distinguishing the functions of the Internal Revenue Service and the grand jury.

As to the construction of section 7602(2), Heaney stated it should be strictly construed contra to the holdings of *Campbell* and *Rosinsky*. The court in *Euge* concluded that Heaney's dissent in *Campbell* should be followed in future Eighth Circuit cases unless the Supreme Court holds otherwise or unless Congress changes the law.\(^8\)

### 8.03 Frivolous Suit Penalty

The Tax Court looks unkindly on dilatory litigation and in the case of *Wilkinson v. Commissioner*,\(^6\) not only did the taxpayer lose the case, but the court tacked on a $500 frivolous suit penalty under authority of section 6673. This section and its predecessors have remained nearly dormant since 1926 when this power was granted.\(^7\) Now it has become a new tool to discourage litigation when the main purpose is to delay tax payment. As the court stated in *Clippinger v. Commissioner*,\(^2\)

> [E]ach year thousands of taxpayers petition this Court to resolve legitimate differences between themselves and the Commissioner over the proper application of the tax laws to their factual situations. Resolution of those differences is unfortunately delayed many times due to frivolous cases such as this.\(^1\)

The Tax Court was still reluctant to use this power as late as 1977, when, in *Hatfield v. Commissioner*,\(^3\) the taxpayer claimed that as a cash basis taxpayer she had no income because federal reserve notes were only accounts receivable until the government redeemed them for real money. The claim was clearly frivolous and a stern warning was given to future litigants with claims of this sort.

Later, in *Clippinger*,\(^4\) the claims also served only a dilatory purpose.

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\(^1\) 587 F.2d at 27.
\(^2\) 71 T.C. 633 (1979).
\(^3\) Rev. Act. of 1924, § 911 as amended by Revenue Act of 1926, § 1000. This power was first exercised in Coombs v. Comm'r, 28 B.T.A. 1216 (1933).
\(^4\) 47 T.C.M. (P-H) ¶ 78,107 (1978).
\(^5\) Id. at 483.
\(^6\) 68 T.C. 895 (1977).
\(^7\) 47 T.C.M. (P-H) at 483 (1978).
There the truck-driving taxpayer had written a pamphlet, "Tired of Being Ripped Off by Federal Income Taxes," then formed a church in his home, donating heavily to it. After he filed his petition, he claimed he lost his church records and so had only the testimony of himself, his niece, and his ledger to vouch for the church’s bona fide existence. However, the court did not levy the frivolous suit penalty stating that this case went to trial before the Hatfield decision, but again issued a warning.

Crowder v. Commissioner, 175 another “tax protester” suit, involved litigation where the taxpayers asserted meritless fourth and fifth amendment claims, and again the court included the Hatfield warning. Roger D. Wilkinson was not so fortunate. His case arose after Hatfield and he admitted knowledge about that decision. Here, taxpayer refused to present any records on his contested itemized deductions. Also, he could not show any legitimate grounds for potential criminal prosecution after the Service notified him of past decisions that baseless fifth amendment claims cannot stand in the way of civil tax liability. 176 The other claims were also frivolous; such as, a signed return is proof of genuineness, or a right to a jury trial in a civil tax case.

The court noted the maximum amount of the frivolous suit penalty had remained at $500 and levied the full amount adding that these costs are wholly inadequate to indemnify the actual costs incurred in this waste of limited judicial and administrative resources. 177

9.00 Inventory

9.01 Inventory Writedowns

In Thor Power Tool v. Commissioner, 178 the Supreme Court decided that the company’s writedown of its excess inventory to estimated net realizable value in conformance with the best accounting practices was not supported by objective evidence of the inventory’s reduced value as required by Regulation 1.446-1 and was properly disallowed by the Internal Revenue Service as not clearly reflective of income.

In Thor, 44,000 inventory items, mostly spare parts, were determined by management to be excess inventory since they were held in excess of any reasonably foreseeable future demand. The taxpayer wrote this inventory down to its "net realizable value," which, in most cases, was scrap value. Although Thor wrote down all its excess inventory at once, it did not immediately scrap the articles or sell them at reduced prices. A taxpayer and the Service are confronted with two general requirements when determining inventory: the inventory method must conform as nearly as

177 71 T.C. at 633.
possible with the best accounting practice and it must clearly reflect income. While section 471 requires only that an accounting practice conform as nearly as possible to best accounting practice, Regulation 1.446-1(a)(2) states that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. Thor protested that its write-down of slow or non-moving inventory was mandated by generally accepted accounting principles (GAAP). Under these rules, the market value of inventory is its net realizable value. Thor contended that it was required by the Regulations to set its closing inventory at the lower-of-cost-or-market value and that the writedown accurately reflected the market value of the excess items.

Thor relied upon Regulation 1.446-1(a)(2) to show that its writedown clearly reflected income. This Regulation states that a method of accounting which reflects the consistent application of generally accepted accounting principles will ordinarily be regarded as clearly reflecting income. Thor interpreted this provision to create a presumption that a taxpayer who shows his accounting method is proper has clearly reflected his income.

However, the Internal Revenue Service asserted that under the lower-of-cost-or-market-value method the market value equals the replacement cost of the goods. Inventory may be valued below market price only if (1) the taxpayer in the normal course of business actually offers merchandise for sale at prices lower than replacement cost, or (2) the goods are unsalable at normal prices or unsalable in the normal fashion because of defects, damage, imperfections or other similar causes. Since the market value of the excess goods under the Regulations was their regular selling price, the Internal Revenue Service protested that the writedown was improper. The Supreme Court agreed with the Service.

In a unanimous decision, the Supreme Court upheld the Service's disallowance of the writedown. Under Regulation 1.471-4, which governs the lower-of-cost-or-market method of inventory accounting, a taxpayer must substantiate a below-market inventory by objective evidence. Not only did Thor fail to sell its excess inventory or offer it for sale at prices below cost, but, more importantly, Thor failed to provide any objective evidence to demonstrate that the excess inventory had the market value management ascribed to it. Rather, the formula governing the write-down was derived from management's collective business experience, but the court concluded that the Treasury Regulations do not permit that kind

179 Id.
180 Under the lower-of-cost-or-market inventory valuation method, a taxpayer compares the market value of each item in his closing inventory with its cost. If an item's market value has dropped to below its cost, the taxpayer enters the item on his closing inventory at that lower value. The write-down results in immediate tax benefits since it decreases closing inventory, thereby increasing cost of goods sold and reducing taxable income.
of evidence. In Thor's case the only way it could establish the inventory's value would be to scrap the excess items at once.

The dilemma facing Thor and other manufacturers that the Supreme Court refused to alleviate was that planned overruns or excess inventory items must be carried for years at cost until sold or sold prematurely to establish a closed transaction. Otherwise, states the Supreme Court, to permit a write-off for excess inventory would enable taxpayers to unilaterally pay the tax they desired and such a choice would render the Code unenforceable.

A careful reading of *Thor* is not a blanket denial of inventory write-downs. The court accepted the validity of the concept of write-downs, but objected to the use of unsupported percentages based on management estimates. The court seemed to be looking for hard data to support the estimated percentages. Careful and complete documentation in support of any inventory write-down is a must. Since the Supreme Court's decision is binding on all taxpayers in similar fact situations, any write-down of excess stock or other market write-downs not conforming to the regulations are not acceptable for tax purposes.

10.00 Pension, Profit Sharing and Stock Ownership Plans

10.01 Lump Sum Distributions

When a taxpayer receives a qualified lump sum distribution, he has three tax-saving alternatives. First, he may treat the pre-1974 portion as capital gain and use the ten-year forward averaging method on the ordinary income portion; or, second, he may treat the entire amount as ordinary income electing the ten-year averaging method for the entire distribution. Thirdly, he may rollover the distribution into an Individual Retirement Account recognizing no current income.

Under the third alternative, the portion of the distribution which is not from the taxpayer's own contributions to the earlier Keogh or employee benefit plan may be transferred into an I.R.A., I.R.A. annuity, or I.R.A. retirement bond. The rollover election must be made within sixty days of receipt. The advantage of the rollover is that the tax is figured only on the amounts withdrawn out of the I.R.A. plan. (However, when this method is used, the special ten-year averaging and capital gain treatment of the funds is forfeited. To avoid adverse consequences, withdrawals may only be made between the ages of 59½ and 70½ and the balance of the fund must be distributed in the year taxpayer reaches 70½. Under this alternative, there are also estate tax advantages since I.R.A. plans are excluded from a taxpayer's gross estate under section 2039(C).

10.02 Partnerships and Corporations

Section 401(a) provides that pension, profit-sharing, and stock-bonus plans must not discriminate in favor of employees who are officers, share-
holders, or highly compensated individuals. However, in spite of the fact that sections 414(b) and (c) provide that employees of partnerships under common control and controlled groups of corporations shall be treated as employed by a single employer; in recent private letter rulings, the IRS stated that only that portion of the total employee compensation equal to each medical corporation's proportionate interest is considered for determining qualification under section 401(a). \(^{181}\)

That ruling concerned a group of doctors involved in a general partnership at a medical clinic. Each wanted to form his own individual corporation which, in turn, would become the general partner. \(^{182}\) The employees of the original partnership would continue working under the new partnership receiving compensation and profit-sharing plan benefits, but each doctor would now become an employee of his own respective corporation and not of the new partnership. \(^{183}\)

Corporations participating in a partnership or joint venture together are required to consider all the employees of the partnership to determine whether the profit-sharing plan qualifies under section 401(a) since the employees of the partnership are considered to be employees of each partner. \(^{184}\) Therefore, each partner-corporation need only take into account its distributive share of the compensation paid to employees of the partnership. \(^{185}\)

In effect, section 414(c) was read with a gloss as though only employees of separate partnerships under common control must be considered in the aggregate. Under the facts here, since the doctors' corporations formed only one partnership, only each partner's share need be considered. \(^{186}\)

10.03 Defined-Benefit Plans

For the owner-employee, Keogh and I.R.A. plans based on a profit-sharing formula have become well known, but there is an alternative. Section 401(j) provides for defined-benefit plans for the self-employed. A defined-benefit Keogh plan is a true pension plan because the contributions must continue based on a previously set formula regardless of the owner-employee's net income. Also, section 401(j)(6) clearly sets out that this type of plan is not subject to the fifteen percent-$7,500 maximum limit. The first step in the computation is to determine the annual income to be received at retirement. This is computed using the table in section 401

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\(^{181}\) Letter Ruling 7905020 (1979); See also, Letter Ruling 7904037 (1979), which has same text.

\(^{182}\) Id.

\(^{183}\) Id.


\(^{185}\) Id.

\(^{186}\) Letter Rulings 7905020 and 7905037.
For example, a taxpayer earning $60,000 per year who commenced participation in the plan at age fifty would use the three percent figure of $50,000 ($50,000 is the maximum compensation allowed in the computation) times .03 or $1,500. Assuming retirement at sixty-five, there are fifteen years times $1,500 so taxpayer can build up an annuity income of $22,500 per year. The next step would be to determine the amount required to be deposited annually that would be sufficient to accumulate enough in the fifteen years before retirement to pay an annuity of $22,500 per year. In this case, the annual deduction would be well over $9,000 in order to accumulate enough capital for the annuity fund. The Code's breakdown of the participation ages is in five-year gaps, but the proposed regulations have a single year breakdown. However, the plan must cover employees with three or more years of service (such as taxpayer's spouse if a bona fide employer) and is subject to the nondiscrimination rules of section 401(a)(4).

10.04 Disqualifications - Attorney's Lien Attachment

Section 401(a)(13) provides that a qualified employee trust must contain a clause against assignment or alienation of the benefits with certain exceptions. The Treasury Regulations further explain this, stating, "... a trust will not be qualified unless the plan of which the trust is part provides that benefits provided under the plan may not be anticipated, assigned (either in law or equity), alienated or subject to attachment, garnishment, levy, execution or other legal or equitable process." A dilemma arises when local law allows an attachment that is not one of the exceptions to this broad prohibition.

The facts in a private letter ruling illustrate how easily the plan could be disqualified. One of the plan's participants contested a denial of a claim for disability benefits. The participant agreed to a written contingent fee of one-third to his attorney, and prior to trial the pension plan agreed to pay the participant a disability pension. The attorney requested to have

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(A) Table.—For purposes of paragraph (2), the applicable percentage for any individual for any plan year shall be based on the percentage shown on the following table opposite his age when his current period of participation in the plan began.

<table>
<thead>
<tr>
<th>Age when participation began:</th>
<th>Applicable percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 or less</td>
<td>6.5</td>
</tr>
<tr>
<td>35</td>
<td>5.4</td>
</tr>
<tr>
<td>40</td>
<td>4.4</td>
</tr>
<tr>
<td>45</td>
<td>3.6</td>
</tr>
<tr>
<td>50</td>
<td>3.0</td>
</tr>
<tr>
<td>55</td>
<td>2.5</td>
</tr>
<tr>
<td>60 or over</td>
<td>2.0</td>
</tr>
</tbody>
</table>

187 (A) Treas. Reg. § 1.401(a) - 13(b).
189 Id.
a lien imposed to satisfy his contingent fee payment under a law which allowed the attorney of record to have a lien on plaintiff's right of action. The plan opposed this, so the attorney asked to have payment due participant paid to the court clerk for one-third distribution to the attorney.

The ruling stated that there is no exception to the anti-alienation requirements for an attorney's lien, so an entire plan would be disqualified if the benefits were attached to enforce an attorney's lien for his services in obtaining this benefit distribution. However, some courts have allowed attachment of plan benefits for enforcing a participant's family support obligations, but the Internal Revenue Service felt such holdings do not extend to an attorney's lien.

This dilemma could also appear after the participant or beneficiary has begun to receive benefits under the plan, because these assignments are not voluntary.191

10.05 Payment by Note

Section 404(a) provides that contributions “paid” to employees' trust are deductible.192 This includes payments made in the form of property. In a recent letter ruling193 a promissory note issued by a third party was considered sufficient payment. This is contrasted with prior case law which disallowed promissory notes as payment deeming them to be only evidences of indebtedness. In Don E. Williams Co. v. Commissioner,194 the promissory note was held not to be within the meaning of “paid.” In that case, the directors of the company contributed promissory notes of the employer company into the profit-sharing trust and took deductions based on the accrual system of accounting. Later, the notes were redeemed by check. The Internal Revenue Service allowed deductions only at the time of the payment by check, and not when the note was issued. There, the note was not a payment, but only a promise to pay, hence “evidence of indebtedness,” there being no actual outlay of cash or property.

However, if the promissory note is issued by a third party, it will be considered property and the employer may deduct its fair market value.195 The facts in the Letter Ruling involved a subsidiary that sold its subsidiary to a group of Canadian citizens in return for a promissory note which was contributed to a pension fund shared with its parent corporation.196 The Internal Revenue Service arrived at a sensible conclusion, albeit circuitously,

191 Treas. Reg. § 1.401(a) - 13(d).
by treating this situation as analogous to installment sales contract provisions.\textsuperscript{197}

In that situation, third-party notes have been held to be payment by property and not "evidences of indebtedness."\textsuperscript{198} Accordingly, the subsidiary's note was a deductible transfer of property and hence "paid" for purpose of section 404.

This writer believes there is a simpler analysis available. In the Williams\textsuperscript{199} case, the note was a note payable on the employer's books, thus it was an obligation owed to another and thus evidence of indebtedness, whereas in the latter situation the note was property when it was a note receivable on the employer's books and thus an obligation owed by another to the employer.

10.06 Limitations on Benefits Raised

The limitations for defined benefit or contribution plans set forth in the Code are subject to administrative cost-of-living adjustments. Effective January 1, 1979, the IRS has set the maximum annual benefit for defined-benefit plans at $98,100\textsuperscript{200} for purposes of section 415(b)(1)(A), and the maximum annual addition for defined contribution plans at $32,700\textsuperscript{201} for purposes of section 415(c)(1)(A). These new limits apply only to these sections and their respective alternate limits have not been changed.\textsuperscript{202}

These figures are the first computed by the Internal Revenue Service using the Labor Department's "All Urban Index," and because of this change the 1974 base period has been adjusted for comparison with this index.\textsuperscript{203} Adjustments to conform to these new provisions do not require determination letters.\textsuperscript{204}

11.00 Corporations

11.01 Liquidation - Basis Valuation

In a recent Letter Ruling,\textsuperscript{205} the IRS has disagreed with the Tax Court regarding the applicable treatment for determining basis valuations of assets acquired by a new organization in plans initiated to buy out co-owners in a closely held corporation. The Tax Court, in Stevens Pass, Inc. v. Com-
missioner, allowed the new corporation to raise the basis of the corporate assets to reflect its purchase price by treating the transaction as a sale under section 334(b)(2). Here, two shareholders of a closely held corporation attempted to buy out the co-owner of the old corporation by forming a new corporation in which the two old corporations, in turn, purchased all shares of the old corporation and soon thereafter liquidated the old corporation pursuant to section 332. The new corporation computed its basis in the assets it acquired through liquidation of its wholly owned subsidiary under section 334(b)(2), and the Tax Court accepted this basis computation rejecting the Internal Revenue Service's argument that the entire transaction should be treated as a section 351 exchange.

With the Stevens Pass decision as background, the IRS restated its argument in Letter Ruling 7905011, where it refused to allow a new corporation to set up the basis of assets which the new corporation acquired from the old corporation in a closely held corporate buy-out setting. The situation involved three actively employed shareholders of the old corporation who formed a new corporation which acquired all the stock of the old corporation and liquidated the old corporation in order to buy out the passive investors' interests. The Internal Revenue Service recognized that these transactions did not qualify as a reorganization under section 368, since the requisite continuity of interest on the part of persons owning stock of the old corporation before the transaction was lacking. Yet, the Internal Revenue Service did consider the transactions characteristic of a section 351 transfer, where the basis of the assets in the old corporation is carried over to the new corporation.

In analyzing this situation, the Internal Revenue Service noted that the economic substance of a transaction or series of transactions "must govern rather than the time sequence or form in which the transaction is cast."

Section 332 provides for the complete liquidation of subsidiaries by parent corporations. Generally, under section 334(b)(1) the basis of the assets of the subsidiary will be carried over to the parent. However, section 334(b)(2) provides an exception in the amount of the basis where at least eighty percent of the voting stock and eighty percent of all other classes of stock of the subsidiary were acquired by the parent by "purchase" during a maximum time period of twelve months. Under this exception the parent's basis in the acquired subsidiary's assets is the parent corporation's adjusted basis in the stock of the subsidiary. The term "purchase" is defined in section 334(b)(3) and excludes the acquisition of stock in a section 351 transfer.

206 48 T.C. 532 (1967).
208 Id.
Relying on this definition of the term "purchase," the Internal Revenue Service reasoned that by treating the formation of the new corporation and the sale of their old corporate stock to the new corporation as one overall plan, and since the three shareholders of the new corporation owned more than twenty percent of the old corporation before the transaction (they held thirty-four percent of the old corporation stock), then this qualified as a section 351 transfer and was not a purchase of stock under section 334(b)(3). Since the stock was not acquired by purchase, section 334(b)(2)(B) prevented section 334(b)(2) from being applicable in determining the basis valuations. Thus, the general rule for basis determination in complete liquidations of subsidiaries contained in section 334(b)(1) was applied rather than the exception.

While the IRS focused its ruling on the fact that eighty percent of the stock was not acquired by purchase because the stockholders of the new corporation owned more than twenty percent of the stock of the old corporation and transferred it under section 351 to the new corporation, such leaves open the possibility that a purchase for basis valuation could be upheld in a similar factual setting if the stockholders owned and transferred less than twenty percent of the old corporation to a new corporation. In this situation, the exception (the stepped-up basis calculation) for basis valuation might still apply.

11.02 Brother-Sister Corporations

Disagreement between the Tax Court and the Internal Revenue Service continues concerning the eighty percent control test applied to brother-sister corporations. Recently, in Allen Oil Co., Inc. v. Commissioner,209 the Tax Court again rejected the Service's arguments and held that each of the five or fewer individual shareholders must be a shareholder of each corporation in order to meet the eighty percent ownership requirements of section 1563(a)(2)(A) for brother-sister controlled group status. The Internal Revenue Service, however, along with the Fourth210 and Eighth211 Circuits, maintains that eighty percent ownership test is met if any one or more shareholders owns at least eighty percent of the outstanding stock of each corporation.

Section 11(b) establishes a surtax exemption of $100,000 for every corporation. However, in the case of certain controlled corporations defined by section 1563, section 1561(a)(1) permits only one surtax exemption to the entire controlled group. For this reason, controversy has developed in interpreting the definitions outlined in section 1563—particularly in determining how to apply the eighty percent ownership test required for

209 1979 T.C.M. (P-H) ¶ 79088.
210 Fairfax Auto Parts of No. Va., Inc. v. Comm'r, 548 F.2d 501 (4th Cir. 1977).
211 T.L. Hunt, Inc. v. Comm'r, 45 T.C.M. (P-H) ¶ 76221, rev'd and rem'd 562 F.2d 532 (8th Cir. 1977).
establishing brother-sister corporations. A control group exists when two or more corporations are “owned” by five or fewer individuals. To constitute “ownership,” two tests—the eighty percent and the fifty percent tests—must be met.

In applying the eighty percent test, the Tax Court holds that each of the five or fewer individuals must be shareholders of each of the corporations involved.\footnote{Id.} The Internal Revenue Service takes the opposite position maintaining that eighty percent control can be established when any one or more of the individuals owns at least eighty percent of the stock of a corporation. In \textit{Allen Oil Co., Inc. v. Commissioner},\footnote{1979 T.C.M. (P-H) at 351.} the Internal Revenue Service argued that the eighty percent test was met when one of the individuals alone owned the required eighty percent stock in a second corporation. The Tax Court disagreed, however, despite the fact that its similar decisions in two prior cases were reversed by the Fourth\footnote{548 F.2d at 501.} and Eighth Circuits,\footnote{522 F.2d at 532.} and that two similar cases are pending appeal in the Fifth\footnote{Delta Metalforming Co., Inc. v. Comm'r, 47 T.C.M. (P-H) ¶ 78354, on appeal (5th Cir., Dec. 6, 1978).} and Ninth Circuits.\footnote{Charles Baloin Co. v. Comm'r, 68 T.C. 620 (1977), on appeal (9th Cir., April 19, 1978).} Since appeal from \textit{Allen} would lie in the Second Circuit, the Tax Court maintains its position because “the Second Circuit has yet to speak on this point.”\footnote{1979 T.C.M. (P-H) at 351.}

To support its contention, the Internal Revenue Service relies on Regulation 1.1563-1(a)(3) which defines a brother-sister control group as a group of two or more corporations where the same five or fewer persons own, either “singly or in combination, the required eighty percent outstanding stock. The first case to challenge this regulation was \textit{Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner},\footnote{Fairfax Auto Parts of No. Va., Inc. v. Comm'r, 65 T.C. 798 (1976), rev'd and rem'd, 548 F.2d 501 (4th Cir. 1977).} where the Tax Court held “that for a person's stock ownership to be taken into account for purposes of the eighty percent test that person must own stock in each member of the brother-sister controlled group.”\footnote{65 T.C. at 803.}

To reach this result, the Tax Court returned to the key language of section 1563(a)(2)(A) and, concentrating on the words “if five or fewer persons . . . own,” pointed out that this clause applied both to the eighty percent and to the fifty percent ownership test. Since ownership of stock in each corporation by each person was a requisite to the fifty percent test, the Tax Court analogized that the same interpretation of the clause was
intended to apply to the eighty percent ownership test as well. The Tax Court also dismissed the Service's argument that such an interpretation would provide "an easy path on which to bypass controlled group status in the brother-sister context." The Tax Court found the regulation to be invalid to the extent that it contradicted the Tax Court's interpretation of the eighty percent test.

In direct contradiction of the Fourth and Eighth Circuits' position, the Tax Court has continually reiterated its Fairfax holding not only in the recent Allen case, but in Charles Baloian Co., Inc. v. Commissioner and in Delta Metalforming Co., Inc. v. Commissioner as well. These two latter cases are awaiting appeal in the Ninth and Fifth Circuits, respectively.

Thus, the manner of application of the eighty percent ownership requirement for determination of brother-sister controlled group status remains a recurring issue, with the proponents of both interpretations adhering to their respective views.

11.03 Reserve for Bad Debts

In Thor Power Tool, the Supreme Court held that additions to a reserve for bad debts cannot be made if the reserve is increased to an amount in excess of that permitted by the six-year moving average of past bad debts. Accrual basis taxpayers can choose one of two accounting methods for their business bad debts. Under the specific debt method, a taxpayer deducts each debt that became worthless during the taxable year. The other method available to accrual-basis taxpayers to account for bad debts is the reserve method. Under the reserve method, a taxpayer establishes an anticipated bad debt account. As debts become worthless, they are charged against the reserve. Similarly, if the taxpayer recovers a debt previously used to reduce the reserve, he does not report it as income, but adds that amount to the reserve. At the close of the year, the taxpayer is permitted to reinstate the reserve to an amount sufficient to cover anticipated bad debt losses for the following year. Only if these additions are reasonable will the Service permit them to be deducted from income.

Section 166(a)(1) requires the taxpayer to consider the total amount of debts outstanding at the close of the taxable year in determining the reasonableness of an addition to a bad debt reserve. However, the previous

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221 Id.
222 Id. at 809.
223 548 F.2d at 501.
224 562 F.2d at 532.
225 68 T.C. at 620.
226 47 T.C.M. (P-H) at 1474.
228 Black Motor Co., Inc. v. Comm'r, 41 B.T.A. 300 (1940).
229 Section 166(a)(1).
bad debt experience of the taxpayer is the critical element in the *Black Motor* method. This method reviews the taxpayer's own experience with losses in previous years and establishes the percentage of accounts receivable that is likely to become worthless during the present taxable year. The percentage is then multiplied by the current year's accounts receivable at the close of the taxable year. The number obtained is a reasonable reserve for bad debts and if the taxpayer's reserve has fallen below this amount, he can make up the difference.

Thor used the reserve method, and during 1965 claimed a deduction for $136,150 as supported by three levels of management. However, the Commissioner ruled that the deduction was excessive and computed a "reasonable" addition to Thor's reserve by using the six-year moving average formula derived from *Black Motor Co.* This figure computed by the Commissioner was $61,359.20 and, accordingly, he disallowed the remaining $74,790 of Thor's claimed deduction. The courts have uniformly held that the Commissioner's determination of a reasonable addition must be sustained unless the taxpayer proves that the Commissioner abused his discretion. The Black Motor Formula has been almost universally accepted for forty years, enjoying the favor of all three branches of government.

While Thor dealt with the ceiling on the annual additions to the bad debt reserve, the Service is also using this decision to end the former flexibility in making additions that were less than the ceiling amounts.

Now the Internal Revenue Service says that a business which computes a reserve for bad debts, under the formula method, must add to the reserve and deduct an amount each year which is necessary to bring the reserve up to the *Black Motor* formula amount. In Revenue Ruling 79-88, All that Glitters Corp., an accrual method manufacturer of costume jewelry, used the reserve method for bad debts. Although Glitters could have increased its reserve by $260 in 1974 and claimed such amount as a deduction, it only increased its reserve by $150 in 1974 to avoid losing the benefit of an operating loss carry forward that could not be carried past 1974.

A taxpayer may not claim, in a subsequent taxable year, a deduction he should have claimed in an earlier year. Since Glitters Corp. could have increased the reserve by $260 at the end of 1974, the Internal Revenue Service ruled that this amount should have been deducted in that year. The addition to the reserve made by Glitters in 1974 was inadequate and caused the 1975 addition to be inflated. The Service denied a deduction for the $110 difference ($260-$150) in 1975. A taxpayer who uses the reserve method may not manipulate bad debt deductions from year to year in

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220 41 B.T.A. at 300.
222 Id.
Thus, businesses which use the reserve method do not have as great a flexibility in deducting annual additions to the reserve for bad debts.

11.04 Waiver of Family Attribution Rules

The Service and the Tax Court have recently presented new approaches to interpreting the waiver of family attribution rules of section 302(c)(2)(A) when implemented by estates and trusts in complete redemption settings. In Revenue Ruling 79-67, the Service approved a procedure whereby an estate can avoid the family attribution waiver problems in certain limited factual settings. This ruling varies from the prior Service position which limits the use of the waiver provisions in section 302(c)(2)(A) to family members only and not to an estate or trust for the benefit of a family member. The Tax Court in Rodgers P. Johnson Trust v. Commissioner, extended this position and now permits trusts to join with estates and individual family members in availing themselves of the waiver provisions of the family attribution rules.

Section 302(a) generally provides that capital gain treatment shall be given to the stockholder in transactions in which a corporation redeems all its stock held by the stockholder. However, section 302(b)(3) also requires that the shareholder must terminate his entire interest in the corporation including any stock interest constructively owned specified under section 302(c)(2). This second requirement causes problems in the family owned corporation where the corporation seeks to redeem all the stock of one family member but where the family member has attributed to him the stock owned by other family members by section 318. To solve this dilemma, section 302(c)(2)(A) outlines a series of requirements that the retiring family member can meet to waive the constructive stock ownership provision of section 318, and to thereby meet the termination of shareholder's interest requirement of section 302(b)(3).

The Service and the courts disagree as to treatment when an estate or trust owns stock in the family-owned corporation, has it redeemed, and seeks to make the waiver of family attribution election under section 302(c)(2) applicable to the estate or trust. The Service has consistently limited applicability of section 302 to family members only. Thus, the Service treats any distributions received by estates and trusts in complete redemptions where constructive stock ownership rules apply as dividends.

In Revenue Ruling 59-233 which dealt with a trust, the Service stated that the waiver of family attribution rules was not available, because

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233 Id.
234 1979-1 C.B. 128.
trusts are deemed to own the corporate stock by virtue of section 318(a)(2)(B) rather than by application of section 318(a)(1). Section 302(c)(2)(A) was limited only to distributees who owned their stock by the application of section 318(a)(1).

Revenue Ruling 68-388 prohibited an estate from applying section 302(c)(2)(A)'s waiver of family attribution rules. Additionally, the Internal Revenue Service disallowed waiver applicability to the individual as well, where, as here, the estate had transferred the stock to the family member who had it redeemed by the corporation, filed the proper waiver agreement with the Service, and paid the estate for the stock with the redemption proceeds. The Internal Revenue Service considered the series of transactions to be "transitory and without economic substance. In reality, the corporation will be considered to have redeemed the stock from the estate."

The Internal Revenue Service followed this same line of reasoning in Crawford v. Commissioner. However, the Tax Court disagreed and held that estates could avail themselves of the waiver-of-attribution provisions of section 302(c)(2), since estates fell within the term "distributee" in section 302(c)(2)(A)(iii). The court rejected the Service's limited definition of "distributee" and indicated concern that the Service's position "will prevent a family member who receives his interest in a corporation through inheritance from terminating this interest in a redemption qualifying under section 302(b)(3) unless the stock is first distributed to him by the estate." The court went on to say that the Internal Revenue Service's position "merely put a premium on tax planning and set a trap for the unwary.

As to trusts, the Tax Court, in Robin Haft Trust v. Commissioner was first faced with the issue of whether trusts can file the waiver agreement of section 302(c)(2)(A)(iii). While the Robin Haft decision did not directly address that issue, the court did distinguish the estate setting of Crawford from that of trusts and specifically stated that they "are not deciding that a trust cannot file the agreement."

Against this background of cases and Service Rulings, the Tax Court received its opportunity this year in Rodgers P. Johnson Trust to fully address the trust issue. A testamentary trust was created by Mr. Johnson's will and named his son as beneficiary. While the son himself owned no

238 1959-2 C.B. at 106.
240 Id.; See also, Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976).
242 Id. at 149.
stock in the corporation, his mother, Mrs. Johnson, did own several shares which under section 318(a)(1)(ii), were attributed to her son. These shares were then reattributed to the trust under section 318(a)(3)(B)(i). When the stock was redeemed by the corporation, the trust and the son each filed agreements with the Internal Revenue Service under section 302(c)(2)(A)(ii) to waive the family attribution rules. The Service repeated its Crawford arguments, but the Tax Court held that the trusts as well as individuals could avail themselves of the waiver provision. The Court again centered its conclusion on the term, “distributee,” in section 302(c)(2) and refused to limit its applicability only to family members in the absence of express language in the Code provision itself.244

The Tax Court indicated that a repurchase of stock in the corporation by the beneficiary might be treated as a reacquisition by the trust itself due to the attribution of ownership provisions of section 318(a)(3)(B)(i). The court, however, stated:

[The issue is not before us and we do not decide it. In the unlikely event that petitioner distributes its assets and ceases to exist before the ten-year period expires, a question would arise whether the waiver filed by [the beneficiary] would bind him as a transferee of petitioner's assets.]245

While the Tax Court has granted use of waiver provisions under section 302(c)(2)(A) to both estates and trusts in addition to the family members themselves, the Internal Revenue Service continues to limit the waiver provision’s availability to individuals and not to entities. In Revenue Ruling 79-67,246 however, the Service provided a method by which estates can avoid the waiver of family attribution problems in specific factual settings. In this ruling, a son and his father's estate owned the family corporation in which the son was active and knowledgeable. The son's mother was the sole beneficiary of the father's estate. The estate transferred its shares to the corporation. The mother retained the proceeds from the redemption and sought to waive the family attribution rules. The IRS accepted her waiver agreement and held that the mother had completely terminated her interest in the corporation. Therefore, the redemption was treated as an exchange under section 302(a). Since the mother's principal purpose in acquiring the stock was to afford her son complete ownership of the corporation, and not to avoid federal income taxes, the Service allowed the preferred capital gain tax treatment to the transaction.

The Service distinguished this Revenue Ruling from its previous decision in Revenue Ruling 68-388.247 Although the rulings involved similar

244 Id. at 532.
245 Id. at 531.
246 1979-1 C.B. at 128.
factual settings, the distinguishing factor seemed to be that here the mother transferred no assets to the estate in exchange for the stock, while in Revenue Ruling 68-388, the mother transferred the redemption proceeds that she received to the estate in exchange for the stock.

11.05 Taxable Boot

To recognize taxable boot in a transfer action under section 351, the substance of transfer must show that the transferor corporation received something besides stock that it didn't already have. In *Wham Construction Co., Inc. v. Commissioner*, the Fourth Circuit has clarified the definition of "other property" in determining what is taxable boot.

Section 351(A) allows one or more persons to transfer property to a corporation solely in exchange for its stock, and if those persons are in control of the corporation after the exchange they will receive fully tax-free treatment. However, if, in addition to the stock or securities for assets, the transferor receives money or "other property" from the transferee corporation, gain will be recognized to the extent of the other property. In *Wham Construction*, the court held that the liability of one division of a corporation wasn't "other property" requiring recognition of gain or loss. Prior to organization of the present Wham Construction Co., Inc., two brothers initially operated the construction company as a partnership, acquiring later an asphalt paving business. In 1959, the brothers incorporated these businesses as one, but still operated them as two separate entities each with its own bank account and separate books. Only one capital account for both businesses was maintained on the construction company books. Since no net income was reflected on the asphalt division books, advances were made by the construction division to the asphalt division which were reflected on the asphalt division books as money "owed" the construction division.

In 1966, the brothers separated their one corporate house into two. They organized Wham Asphalt Company, Inc., which issued all of its capital stock to Wham Construction in exchange for cash, receivables, inventory, and capital assets which, net of certain liabilities, would permit continuation of the asphalt paving business. Listed on the new asphalt company books was an account payable to the parent construction company of $160,402. Several months later, the asphalt company paid this amount to the parent.

The Service contended that this payment was ordinary income (some of the property was depreciated property triggering the recapture provisions of section 1245) to the parent, taxable because of section 351(B) as "other property."

249 Id.
The Fourth Circuit reasoned that if Construction had merely loaned its subsidiary operating capital, there would have been no income to Wham on repayment. In effect, all Asphalt had done was return some of the cash and receivables it had received from Construction on incorporation.\textsuperscript{250}

Therefore, repayment of an inter-company account balance will not be characterized as “boot” and as a result will not trigger income to transferee.

\section*{11.06 Exemption for Franchisee Association}

Settling a conflict between the Second and Seventh Circuits, the Supreme Court ruled, six to three, that an association of Midas Muffler dealers does not qualify as a tax-exempt business league and denies non-industry-wide associations the tax-exempt status of business leagues.\textsuperscript{251} In \textit{Pepsi-Cola Bottlers' Ass'n v. United States},\textsuperscript{252} the Seventh Circuit held that an association whose members were engaged in the bottling and sale of a single franchised soft-drink product, and whose activities were directed to the more efficient production and sale of that product, qualified for exemption from the federal income tax as a business league under section 501 (c) (6).\textsuperscript{253} In \textit{National Muffler},\textsuperscript{254} the Second Circuit affirmed a district court finding that an association of Midas Muffler franchisees was not a business league and not entitled to exemption within the meaning of section 501 (c) (6).

The organization was formed by Midas Muffler franchised dealers to negotiate with Midas and has been successful in obtaining changes in the standard Midas franchise agreement. In 1972, its bylaws were amended to eliminate the requirement that its members be Midas franchisees. However, despite an announced purpose to promote the interests of all muffler dealers, the organization never recruited nor acquired any member who was not a Midas franchisee.

The Pepsi-Cola Bottler's Association was formed in 1949 “to promote, extend, further protect and improve the trade and business of bottling and selling Pepsi-Cola.” The Internal Revenue Service rejected its application for tax-exempt status on the ground that it failed to represent the line of business of bottling all soft drinks, and it benefited only its own members and therefore did not benefit the line of business in general. However, in 1966, the Seventh Circuit granted the association a tax exemption based

\textsuperscript{250} \textit{Id.} at 5261.
\textsuperscript{252} 369 F.2d 250 (7th Cir. 1966).
\textsuperscript{253} Under § 501 (a), an organization described in subsection (c) is exempt from taxation. Section 501 (c) (6) provides that certain organizations are referred to in § 501 (a), including "business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholders.”
\textsuperscript{254} 565 F.2d 845 (2nd Cir. 1978).
on the reasoning that a business league need not be devoted entirely to
general public welfare. Because the group contributed to the improvement
of the Pepsi-Cola bottling business, it also benefited the general consumer
public. The court held that the IRS line-of-business requirement was un-
reasonable and unsupported by legislative history. Promptly following this
decision, the IRS in Revenue Ruling 68-182\textsuperscript{285} announced it would not
follow the Pepsi decision and reaffirmed the validity of its line-of-business
standard.

Upon granting certiorari to resolve this conflict among the circuits,
the Supreme Court focused on the key issue of the validity of a Treasury
Regulation\textsuperscript{286} that defines a business league as one that promotes a "line
of business", as opposed to a "group in competition with another within an
industry." The tax exemption for business leagues, chambers of commerce,
and boards of trade has been in effect since the beginning of the modern
income tax system in 1913. Unlike chambers of commerce and boards of
trade, however, the term "business league" had no settled meaning at that
time.

Regulation 1.501(c)(6)-1 states that a business league is one that
directs its activity "to the improvement of business conditions or to the
promotion of the general objects of one or more lines of business as dis-
tinguished from the performance of particular services or individual persons."

Calling it the Commissioner's function, and not the judiciaries, to
choose among reasonable interpretations of a taxing statute, the majority of
the court said that the "line-of-business" requirement is well grounded in
the legislative history and purpose of the business league exception. The
legislative testimony submitted by groups that led to the adoption of the
business league exemption indicates that the exemption was meant for
organizations composed of businessmen working to promote the common
interest of all the "members of their communities of their
\textsuperscript{285}1968-1 C.B. 263.
\textsuperscript{286}Treas. Reg. § 1.501 (c)(6)-1.
\textsuperscript{287}440 U.S. at 472.
might inquire into whether the membership of an association is industry wide and, if not, whether due effects were being made to attract industry-wide membership.

11.07 Type B Reorganization

The Tax Court in *Reeves v. Commissioner* broke away from the long-standing rule that a reorganization is tax free only if made “solely for voting stock” of the acquiring corporation. Prior to this case, this requirement has been interpreted by the courts as meaning that any cash or other property payments will disqualify the tax-free status of a Type B reorganization. In *Reeves*, the Tax Court held that cash payments won’t nullify a Type B reorganization so long as at least the required eighty percent of the target corporation is acquired in a transaction solely for stock. Two months after release of the *Reeves* opinion, the District Court of Delaware decided *Pierson v. United States*, which reached the same result as *Reeves*. However, more importantly, Pierson does not appear to have narrowed its holding to the “eighty percent solely for stock” standard applied by the Tax Court in *Reeves*.

A frequently used method of acquiring a corporation is the stock-for-stock exchange commonly known as a Type B reorganization. To achieve tax-free status, the following technical requirement stated in section 368(a)(1)(B) must be met:

...the acquisition by one corporation, in exchange solely for all or a part of its voting stock ... of stock of another corporation, if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition.)

The use of cash by the acquiring corporation in any transaction deemed to be a part of the acquisition has frequently caused an intended B reorganization to be viewed as a taxable sale or exchange. In order to ensure that shareholders do not abuse these nonrecognition provisions by casting in the form of nontaxable reorganizations transactions that are basically sales of stock, a number of conditions are imposed before nonrecognition is available. In the “stock-for-stock” or Type B reorganization, the critical inquiry is often whether the exchange is made “solely” for voting stock.

This strict interpretation of the word “solely” was relaxed somewhat by the Fifth Circuit in *Mills v. Commissioner*. In this case, three small gas corporations were merged into a larger corporation. Rather than issue fractional shares to make up the balance of the exchange price, the acquiring corporation paid each shareholder $27.36 in cash to close the deal. The Fifth Circuit reasoned that the parties intended a stock-for-stock exchange, and the cash was merely incidental to eliminating the problem of fractional

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21 331 F.2d 321 (5th Cir. 1964).

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shares. However, the IRS continued to literally construe the word "solely" in stock-for-stock exchanges.\(^2\)

In *Reeves*, the court was confronted directly with the need to determine the proper scope of the "solely for voting stock" requirement of section 368 (c)(1)(B). In this case, International Telephone and Telegraph Corporation was interested in acquiring Hartford Fire Insurance Company, so it proposed a merger, a stock-for-stock exchange which was completed in May, 1970. The only question before the Tax Court was whether these transactions constituted a valid B reorganization whereby a controlling interest (80%) in the stock of a corporation is acquired "solely" for the stock of the acquiring corporation. The Tax Court interpreted the "solely" requirement as applying only to the minimum amount of stock needed to obtain control subject to a *literal* interpretation of the term "solely" (i.e., eighty percent of the target corporation’s stock must be obtained from shareholders who receive *only* stock consideration). Such a reading of the case gives full effect to the "solely" language of the statute while still permitting some latitude for cash in a B reorganization. It departs from the traditional view in that the "solely" requirement is applied only to the amount of stock needed to obtain control as opposed to whatever stock is acquired in the reorganization. Here, the acquisitions for cash did not coincide with the stock-for-stock exchange.

After *Reeves* was decided, the District Court of Delaware in a case involving another former Hartford shareholder (involving the same ITT-Hartford exchange as in *Reeves*) reached the same result in holding that the transaction qualified as a B reorganization. In *Pierson*,\(^3\) the district court held that in a *single* transaction, if eighty percent of the acquired corporation’s stock is exchanged for voting stock in the acquiring corporation, it will qualify as a B reorganization notwithstanding the payment of cash or other nonstock consideration within the same transaction. This holding in *Pierson* differs in some important aspects from the holding in *Reeves*, although they both reach the same conclusion. In *Pierson*, the district court’s opinion was unequivocal in stating that the cash and stock were part of the *same transaction*. More importantly, the district court apparently has not narrowed its holding to the “eighty percent solely for stock” standard applied by the Tax Court in *Reeves*. In fact, the *Pierson* case may stand for a broader “eighty percent for stock” rule. If this is so, a transaction would qualify as a B reorganization where eighty percent of the acquired corporation’s stock is acquired for stock, although some or all of the shareholders receive cash or other nonstock consideration. It remains to be seen whether these liberal interpretations will be followed or whether courts will return to the traditional interpretations.

### 12.00 Subchapter S Corporations

\(^3\) 43 A.F.T.R. 2d at 1228.