FEDERAL INCOME TAX DEVELOPMENTS: 1981
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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1981 is the ninth of an annual series of articles to be published in the Akron Law Review. The scope of this survey is limited to the substantive developments in the field of income taxation. The thrust of this article is not only to identify new developments, but also to trace these concepts through their formulative changes.

Given the volatile nature of taxation, it is crucial for the practitioner in this field to remain current with the changes which occur during the year. Research for this article includes cases decided through August 31, 1981.

In an attempt to minimize the lead time between research and publication, this author has engaged the most able assistance of third year law students. Without their substantial contributions and complete dedication, this article would not have been possible. The author, therefore, wishes to recognize and thank the following students for their efforts in researching, writing and compiling this article:

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A. Supreme Court Cases

A-1.00 Retroactive Tax Application

Early in 1981, the Supreme Court decision in *United States v. Darusmont*
upheld the constitutionality of a retroactively applied increase in the

\(^{1}\) 101 S. Ct. 549 (1981).
income tax rate for a tax preference item as enacted under the Tax Reform Act of 1976.\(^2\)

Section 301\(^3\) of the Tax Reform Act of 1976 amended section 56(a) of the 1954 Code.\(^4\) The amendment increased the rate of minimum tax on preferences from ten to fifteen percent and reduced the exemption to the greater of $10,000 or one-half the regular tax liability (with certain adjustments). Section 301(g)(1) retroactively applied the amendments of that section to tax preference items for tax years after December 31, 1975, with certain exceptions.\(^5\)

In *Darusmont* the taxpayer attacked the retroactive application of section 301. During the first half of 1976, the taxpayer had certain property to sell.\(^6\) He and his real estate agent analyzed the various income tax consequences that could result, depending on how the sale was handled, and selected a plan of tax treatment. The property was sold on July 15, 1976. The taxpayer computed his income tax under the tax laws then in effect and determined that he would have no tax liability on the transaction. However, on October 4, 1976, the President signed into law the Tax Reform Act of 1976. Due to the retroactive application of the new law, the taxpayer was charged with a deficiency of $2,280 relative to this property transaction.

The district court found that the retroactive amendments constituted a "new, separate and distinct tax"\(^7\) and concluded that as a matter of law the circumstances of its application made it "not only harsh and oppressive but basically unfair, and violative of the Fifth Amendment to the United States Constitution."\(^8\) The government appealed directly to the Supreme Court.\(^9\)

The Supreme Court noted that almost every income tax statute has had a retroactive application.\(^10\) Generally the retroactive period has applied only to the part of the calendar year that preceded the date of signing. However, there have been two tax enactments which included a retroactive period of a full year prior to the signing.\(^11\) The Court labeled the retroactive

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\(^3\) 26 U.S.C. § 56 (1976)

\(^4\) I.R.C. § 56(a).

\(^5\) *Darusmont v. United States*, 80-2 U.S. Tax Cas. (CCH) 19671 (E.D. Cal. 1980).

\(^6\) Id.

\(^7\) *Darusmont* v. United States, 101 S. Ct. at 550-51.

\(^8\) *Darusmont* v. United States, 101 S. Ct. at 550-51.

\(^9\) Appeal was taken pursuant to 28 U.S.C. § 1252 (1976) which provides that direct appeal to the Supreme Court may be taken when a statute is held to be unconstitutional in any civil action to which the United States is a party.


\(^11\) Id. at 552 referring to Revenue Act of 1918, ch. 18, § 200, 40 Stat. 1057 (1919) and Revenue Act of 1926, ch. 27, § 200(a), 44 Stat. 9 (1926).
application of an income tax increase a "customary congressional practice."

Further, the Court stated that the minimum tax rate preference item could not be called "new" since it was first applied in 1969 and even then applied to the very type of taxable subject being litigated: "the untaxed portion of any net long-term capital gain."

The taxpayer conceded that a retroactive tax application did not violate the Constitution per se. However, the taxpayer contended, there are three separate tests which must be applied to determine if a tax as applied is violative of due process.

The first test was whether a taxpayer could have acted differently at the time of the transaction; could he have anticipated and avoided the tax? Cases cited by the taxpayer to support this argument were gift tax cases, but the Court found them not controlling precedent in a federal income tax case.

Secondly, the taxpayer argued that he must have had notice of the tax at the time of the transaction in order for the tax rate increase to be applied. The Court assumed per arguendo that personal notice was relevant but did not so decide. On this point, the Court concluded that the taxpayer had ample notice because "[t]he proposed increase in rate had been under public discussion for almost a year before its enactment."

The third test proposed by the taxpayer to review a tax under the Due Process clause was whether it was an imposition of a new tax or merely an addition to an existing tax. The Court stated that what was in issue was simply a variation of a rate of an already existing tax. The Court quoted with approval remarks made by Judge Learned Hand:

Nobody has a vested right in the rate of taxation, which may be retroactively changed at the will of Congress at least for periods of less than twelve months; ... His is a different case from that of one who, when he takes action, has no reason to suppose that any transactions of the sort will be taxed at all.

The Supreme Court did not decide with finality the constitutionality of a retroactive application of a tax increase that would pre-date the statutory enactment by more than twelve months. Also, the Court implied that the retroactive application of a new tax would not be allowed.

The Court's analysis was soft in several areas. The Court discussed without deciding if, in fact, personal notice of a tax rate increase is re-

12 United States v. Darusmont 101 S. Ct. at 552.
14 United States v. Darusmont, 101 S. Ct. at 553.
15 Id.
16 Id.
17 Id. at 552-53.
18 Cohan v. Commissioner, 39 F.2d 540, 545 (2d Cir. 1930) (emphasis added).
The per curiam opinion does not offer any hope for a different judicial finding given similar facts. Briefly, by calling the retroactive application of a tax rate increase a "customary congressional practice" the Court pointed to the only entity that might vary the practice: Congress itself.

A-2.00 Percentage Depletion Allowance

The United States Supreme Court decided in Swank v. United States than an otherwise eligible lessee of underground coal is not prevented from having an economic interest in the coal in place because the lease contained a clause permitting the lessor to terminate the lease without cause on thirty days' notice. The IRS has consistently ruled that a lessee does not have an economic interest where the lease is terminable without cause on thirty to sixty days' notice by the lessor. Absent an economic interest the IRS has not allowed the lessee to utilize the Code's depletion deduction. The Swank holding stands in contradiction to the IRS's position regarding who is entitled to depletion deduction when a lease of underground coal contains a clause providing for termination on short notice.

In Swank the taxpayer operated a coal mine pursuant to a lease. In exchange for a fixed royalty per ton, the lessor granted the lessee the right to extract and sell the coal at prices fixed by the lessee. The lease provided the lessor with the right to terminate the lease on thirty days' notice. Only the lessee sought a percentage depletion deduction claiming an economic interest in the coal.

The Code does not mandate a minimum duration of interest in mineral deposits for purposes of the depletion deduction. The treasury regu-
lations merely require the taxpayer to have an "economic interest" in the minerals.\textsuperscript{25}

The government first argued that the taxpayers possessed only an economic advantage, rather than the required economic interest in the coal deposits.\textsuperscript{26} The Court found that the taxpayer had a significant legal and financial interest in the coal, both before and after it was mined, where he was free to extract the coal, set its price, and then sell it on the open market. In short, the Court held that the taxpayer had a depletable economic interest rather than an economic advantage.

The government next contended that "as a matter of practical economics," the lessors' right to terminate the lease gave them control of the only significant economic interest in the coal.\textsuperscript{27} The Court rejected this argument and affirmed the conclusion reached by the Court of Claims that "the mere existence of the lessors' unexercised right to terminate these leases did not destroy the taxpayers' economic interest in the leased mineral deposits."\textsuperscript{28} In addition, it was held that "the Government has not suggested any rational basis for linking the right to a depletion deduction to the period of time that the taxpayer operates a mine."\textsuperscript{29}

In a strong dissent,\textsuperscript{30} Justice White stressed the Court's duty to determine only whether or not the IRS's interpretation of the law was reasonable. The dissent's view was that the IRS construction of the statute was acceptable in this case. To support his opinion, Justice White pointed out that the economic advantage-interest distinction was adopted in the treasury regulations and that the Court has explicitly accepted this distinction in prior cases.\textsuperscript{31}

The Supreme Court's decision in \textit{Swank} to allow the use of the in-place depletion allowance provision may be interpreted as demonstrating a swing towards favorable treatment of energy resource development.

A-3.00 Tax-Exempt Organizations

In \textit{HCSC-Laundry v. the United States}\textsuperscript{32} the Supreme Court was asked to determine whether a cooperative hospital laundry service qualified as a tax-exempt organization under the Code. The decision turned on an interpretation of sections 501(c)(3) and 501(e) which specify the types of hospital service organization that qualify as charitable organizations.

\textsuperscript{25} Treas. Reg. § 1.611-1(b), 26 C.F.R. § 1.611-1(b) (1980).
\textsuperscript{26} 101 S. Ct. at 1937. The government relied on Parsons v. Smith, 359 U.S. 215 (1959), and Paragon Jewel Coal Co., Inc. v. Commissioner, 380 U.S. 624 (1965) where the Court held that mining contractors had only an economic advantage in coal deposits.
\textsuperscript{27} 101 S. Ct. at 1939.
\textsuperscript{28} Id.
\textsuperscript{29} Id.
\textsuperscript{30} Id. at 1939 (White, J., joined by Stewart, J., dissenting).
\textsuperscript{31} Id. at 1940.
\textsuperscript{32} 101 S. Ct. 836 (1981).
In 1967, HCSC-Laundry was formed as a nonprofit organization to relieve fifteen area hospitals of the maintenance and expense of individual laundry and linen supply systems. Application was made to the IRS in 1976 for exemption under section 501(c)(3) which lists the types of organization excluded from paying taxes to the federal government. Since each of the fifteen hospitals served possessed a certificate of exemption under this section, the HCSC-Laundry contended that the laundry service was merely an extension of these organizations and should also qualify for exemption. The IRS took the position that section 501(e) contained an exclusive list of all the cooperative hospital service organizations which qualified. Since laundry services were not included in the listing, the IRS denied HCSC-Laundry's application.

After paying the taxes and receiving no response to its application for a refund within six months, HCSC-Laundry filed suit in the United States District Court which found in its favor. On appeal, the court of appeals reversed holding that section 510(e) was the exclusive provision to which a hospital service could look for exemption.

In upholding the court of appeals' decision, the Supreme Court referred to the legislative history of section 501(e) and noted that laundry services had been discussed for possible inclusion in the listing but had been eliminated from the final draft. The court felt that this clearly showed that the legislative intent was to exclude, rather than to include, laundry services from the list of exempt organizations.

In addition, the court noted that the basic premise underlying income taxation is that all income is taxable unless excluded by statute or rule of law. Therefore, the court reasoned, unless it could be shown that cooperative laundry services were specifically meant to be included as eligible for exemption, income from such an organization would be subject to taxation.

The dissent in this case views section 501(e) as capable of broader interpretation than it was given by the majority in that it does not state that its list is exhaustive. Furthermore, even if section 501(e) is not available to petitioner, it seems reasonable to the dissent to grant tax exempt status under section 501(c) (3) read in light of section 501(a) which provides for that status unless specific denial is found under section 502 or 503.

This decision was based primarily on the legislative history of section 501(e). The fact that inclusion of laundry services had been discussed and rejected on more than one occasion was persuasive. In interpreting statutes, the court states that it is obliged to discover the legislative intent whenever possible. In this case, that information was available to the court.

88 Id. at 837. 84 Id. at 838. 85 Id. at 839. 86 Id. at 838. 87 Id. at 840 (Stevens, J., dissenting).
A-4.00 Attorney-Client Privilege

In Upjohn Co. v. United States, the United States Supreme Court granted certiorari to determine whether the work product doctrine is applicable to avoid tax summonses and whether the attorney-client privilege covers communications between a corporation's employees and its general counsel.

Upjohn, a manufacturer of pharmaceuticals, was summoned by the IRS to turn over results from an internal investigation it had conducted relating to questionable payments made by its foreign subsidiaries to foreign government officials to secure government business. The investigation was conducted by Upjohn's general counsel and included questionnaires sent to all foreign managers and interviews with company officers and employees. On the basis of its findings, Upjohn voluntarily reported to the SEC some of the details surrounding the payments. During a later audit by the IRS, the SEC turned over these reports and the IRS demanded additional information from Upjohn so as to make an independent evaluation of the tax consequences. Upjohn refused to comply with the IRS summons demanding the questionnaires and notes from the interviews contending that they were protected under the attorney-client privilege and constituted the work product of attorneys.

The United States filed a petition in Federal District Court seeking enforcement of the summons. Upjohn thereafter appealed the finding of the district court that the summons should be enforced.

The Sixth Circuit Court of Appeals examined two tests that have been used in relation to the attorney-client privilege in the corporate setting. The "subject matter" test looks to the nature of the information and how it was acquired by the corporate agent. Under this test if the agent acquired the information in the ordinary course of his employment and it is confidentially related to corporate counsel to enable him to give legal advice to the corporate officers, it is protected. The Sixth Circuit rejected this test in favor of the narrower "control group" test which extends the privilege only to the top officers in a corporation who would play an active role in deciding how the corporation would react to the legal advice given. The court felt this test was broad enough to satisfy the purposes of the privilege: protecting privacy in the attorney-client relationship and promoting free flow of information. The "subject matter" test, the court reasoned, would

41 Id. at 1226. The Second and Third Circuits favor this test. Id.
42 Id. at 1227.
43 Id. at 1226. The Seventh and Eighth Circuits rely on this test. Id. at n.8.
tend to create a "zone of silence" by corporate management encouraging its agents to communicate with counsel so as to render it undiscoverable. The case was remanded to the district court to determine which communications under the IRS summons were made by Upjohn's "control group" and thereby protected. The United States Supreme Court granted certiorari in view of the split in the federal court regarding the attorney-client privilege. The Court held that the communications made by Upjohn's employees fell within the scope of the attorney-client privilege and that the work-product doctrine applies in tax summons enforcement proceedings.

The Court rejected the "control group" test in that it "overlooks the fact that the privilege exists to protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice." The Court reasoned that use of this test would frustrate the purpose of the privilege by discouraging the free flow of information to corporate counsel.

The work product doctrine was held by the Court to apply to IRS summonses. Strong public policy reasons were the basis for this aspect of the holding in that such protection of privacy must attach to the attorney's work and thought processes.

Even though the Upjohn decision appears to give specific guidelines for the future, there will continue to be room for argument under the facts of different cases. The decision must be read in light of the Supreme Court's explicit refusal "to lay down a broad rule...to govern all conceivable future questions in this area."

A-5.00 Workmen's Compensation Integration

In Alessi v. Raybestos-Manhattan Inc., the United States Supreme Court decided the issue of whether or not workmen's compensation benefits could be offset against pension benefits. Prior to this decision, the IRS determined in revenue rulings issued prior to the enactment of the Employee Retirement Income Security Act of 1974, (ERISA) that workmen's compensation payments could offset pension plan payments. In 1978, the Sixth Circuit held that to reduce pension benefits in such a manner would be impermissible under the nonforfeitability provisions of ERISA.
Alessi involved two separate suits brought in New Jersey state courts by retired employees of Raybestos-Manhattan, Inc. and General Motors Corp. [hereinafter referred to as petitioner corporations]. Each of these corporations maintained employee pension plans which provided for the reduction in the employee's retirement benefits by an amount equal to the workmen's compensation award for which the individual is eligible. The pension plans are subject to federal regulation under ERISA.

In 1977, the New Jersey Legislature amended that state's Worker's Compensation Act to prohibit such offsets. Thereafter, the retired employees alleged that the petitioner corporations had violated the amended state act. The corporations removed the suits to the United States District Court which held that the pension offset provisions were invalid under New Jersey law and were prohibited by ERISA. The district courts also struck down a treasury regulation which authorized such offsets. The Third Circuit Court of Appeals consolidated the appeals from the two district courts decisions and reversed the holdings.

The Court, in Alessi, agreed with the determination of the court of appeals that offset provisions of private pension plans which reduce a retiree's benefits by the amount of workmen's compensation awards received prior to retirement do not cause a forfeiture of vested rights. The Court stated that in enacting ERISA, Congress permitted integration of pension plan benefits with Social Security benefits. The Court also noted that ERISA does not mention integration with workmen's compensation. In resolving this controversy, the Court stressed the fact that Congress was aware of the revenue rulings which expressly approved the reduction of pension benefits by the amount of workmen's compensation for which an individual is eligible, yet left these rulings in effect by enacting ERISA. The Court reasoned that by not directly addressing the dispute, Congress intended to embrace the revenue rulings.

With the Supreme Court's approval, employers may now reduce certain employee benefits by the integration of the pension plan with workmen's compensation as well as with the social security integration previously used.

A-6.00 Letter Ruling as Evidence

In Rowan Companies, Inc. v. United States, the Supreme Court held

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54 101 S. Ct. at 1898.  55 Id.
56 N.J. STAT. ANN. § 34: 15-29 (West 1959) (as amended by 1977 N.J. Laws, ch. 156). In Alessi, the Court held that this statute was pre-empted by ERISA. 101 S. Ct. at 1906.
59 Buczynski v. General Motors Corp. 616 F.2d 1238 (3d Cir. 1980).
60 101 S. Ct. at 1899.  61 Id. at 1901.  62 Id. at 1904.
63 Id.  64 101 S. Ct. 2281 (1981).
that an employer need not pay Social Security (FICA)\(^{65}\) and Federal Unemployment Insurance (FUTA)\(^{66}\) taxes on the value of meals and lodging furnished to employees where section 119 of the Code\(^{67}\) applied to exclude such items from income. As a result of this important decision, the withholding requirements for Section 119 benefits\(^{68}\) should be eliminated and employers will most likely claim refunds for over-paid taxes.\(^{69}\)

At issue in *Rowan* was whether an employer was required to include the value of meals and lodging, which he provided to employees for his own convenience, in the computation of wages for the determination of FICA and FUTA taxes.

The IRS relied on the FICA and FUTA tax regulations\(^{70}\) concerning “facilities or privileges,” which subject the value of meals and lodging to FICA and FUTA taxation as wages. The interpretation of “wages” found in these regulations conflicts with section 119 which excludes the value of meals and lodging provided for the convenience of an employer from an employee’s income and exempts such items from income tax withholding.\(^{71}\)

The Court resolved this dispute by holding the FICA and FUTA tax “facilities or privileges” regulations invalid.\(^{72}\) The Court stressed the need for consistency between specific statutory language and interpretive regulations. Wages was specifically defined by Congress for FICA, FUTA and income tax withholding purposes.\(^{73}\) Therefore, the “facilities or privileges” regulations interpretation of the term wages, in a manner which was inconsistent with the statutory language, was accorded little significance.

The consistency standard adopted by the Supreme Court in *Rowan* should quell the Service’s assault on fringe benefits.\(^{74}\) It is clear that any regulation defining the term wages for FICA and FUTA purposes, must be

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\(^{65}\) I.R.C. § 3101 et. seq. [hereinafter, the term Social Security tax shall be referred to as FICA].

\(^{66}\) I.R.C. § 3301 et. seq. [hereinafter, the term Federal Unemployment Insurance Tax shall be referred to as FUTA].

\(^{67}\) I.R.C. § 119.

\(^{68}\) I.R.C. § 3402(a) provides that “every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables prescribed by the Secretary.”


\(^{70}\) See Treas. Reg. §§ 31.3121(a)-1(f) (1975) and 31.3306(b)-1(f) (1975).

\(^{71}\) I.R.C. § 119.

\(^{72}\) 101 S. Ct. at 2297.

\(^{73}\) Wages, for FICA and FUTA purposes, was defined by Congress as “all remuneration for employment.” See I.R.C. § 3121(a) and 3306(b). For purposes of income tax withholding, wages was defined as “all remuneration . . . for services performed by an employee for his employer.” See I.R.C. § 3401(a).

\(^{74}\) See Rev. Proc. 80-53, 1980-2 C.B. 848, where the IRS states that fringe benefits exceeding $600 be reported on an employee's W-2 form even though no withholding is required.
consistent with the definition of wages for purposes of income tax withholding.\footnote{Kovey & Winslow, supra note 69, at 136.}

The significance of \textit{Rowan} extends beyond its promulgation of the consistency standard. \textit{Rowan} represents the first time the Supreme Court acknowledged that a private letter ruling may be admitted as evidence in a court proceeding.\footnote{101 S. Ct. at 2296.} The Court cited numerous private letter rulings as evidence that over an eleven-year period, from 1954 to 1965, the IRS had failed to construe the term "wages" in a consistent manner with reference to its tax treatment of meals and lodging provided by employers for their own convenience, to employees.\footnote{Id.}

While using these rulings as evidence of inconsistent tax treatment by the IRS, the Court made it clear that private letter rulings have no precedential value and concern only the taxpayer who requested the ruling.\footnote{See also I.R.C. § 6110(k)(3) and Treas. Reg. § 301.6110-7(b) which provide that a private letter ruling has no precedential value.} Such language serves as a reminder that private letter rulings are not to be relied upon as precedent for any tax issue.\footnote{See Kovey & Winslow, supra note 69, at 130.}

\section*{A-7.00 Mining and Nonmining Costs}

In \textit{Commissioner v. Portland Cement Co. of Utah},\footnote{101 S. Ct. 1037 (1981).} a dispute arose between the IRS and an integrated mining-manufacturing company concerning the company's method of calculating depletion.\footnote{See I.R.C. § 611.} The Supreme Court was asked to interpret the term "first marketable product" as it is used in section 611.

Portland Cement Company mined cement rock, processed it into cement, and sold the cement in bulk and by bag. In calculating its constructive gross income from its mining operations, the company elected to use the proportionate profits method. This method uses the costs from and proceeds of the company's "first marketable product." The company took the position that the "first marketable product" was cement sold in bulk only, and therefore excluded the bagging costs and premiums (the increase for selling cement in bags) from its calculations. Because bagging costs exceeded premiums, this exclusion resulted in a greater constructive income for the mining operations, which therefore increased the percentage depletion amount allowed. The IRS contended that the bagged cement was the "first" marketable product, and therefore bagging costs and premiums should be included in the calculations of mining gross income.

The Regulations define "first marketable product" as "the product (or group of essentially the same products) produced by the taxpayer as a result
of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in taxpayer's marketing area."\textsuperscript{82} The regulations also state, "For this purpose, bulk and packaged products are considered to be essentially the same product."\textsuperscript{83}

Portland Cement, which used the "proportionate profits" method, agreed that the treasury regulations were not unreasonable. However, the company urged the Court to focus on the facts of Portland Cement's particular situation, and argued that if the regulations were strictly applied to the company, the percentage of profits from mining would be distorted, resulting in a lower constructive gross income and, therefore, a lower depletion allowance. This distortion, the company, contended, is a result of an acceptance of a basic assumption upon which the "proportionate profits" method is based: i.e., that each dollar of costs earns the same percentage of income regardless of whether the costs are incurred during mining or during manufacturing. It was argued that this was not a valid assumption in this case since Portland Cement's profit margin on bagged cement was less than on bulk cement. Relying on United States v. Cannelton Sewer Pipe Co.,\textsuperscript{84} Portland Cement contended that the mining phase should be viewed as an independent entity and that profits derived from that phase should not be diluted by costs incurred in the manufacturing phase. Portland took the position that only costs incurred in the production of bulk cement should be considered since the incremental costs incurred in bagging the cement exceeded the incremental revenue derived from the sale of bagged cement, resulting in a lower profit against which depletion could be taken.

The Supreme Court reversed the court of appeals and upheld the Commissioner's position that costs incurred in the production of both bulk and bagged cement should be used in the calculations. The Court stated that the meaning of the statute was clear and that special treatment for this taxpayer was not warranted.\textsuperscript{85} First, Portland Cement had been given the opportunity to submit an alternative method of depletion to the IRS for approval but did not do so.\textsuperscript{86} Secondly, the taxpayer was in good financial health and this was not a matter of creating a loss versus a profit by a rigid application of the regulations, but rather a lower marginal profit versus a higher marginal profit upon which the depletion percentage would be applied. In addition, and most importantly, the Court reasoned that the "proportionate profits" method was never intended to be a precise reflection of profits but was merely an approximation.\textsuperscript{87} As such, integrated mining-manufacturing operations which use the "proportionate profits" method must

\textsuperscript{82} Treas. Reg. § 1.613-4(d)(4)(iv) (1972).
\textsuperscript{83} Id.
\textsuperscript{84} 364 U.S. 76 (1960).
\textsuperscript{85} 101 S. Ct. at 1045.
\textsuperscript{86} Id. at 1041.
\textsuperscript{87} Id.
accept the fact that its application will result in variations from company to company and from industry to industry.

As a result of this case, integrated mining-manufacturing companies which must calculate a constructive gross income for depletion purposes would be wise to analyze thoroughly the production costs of their “first marketable product” and consider applying to the IRS for approval of an alternative method if distortions in gross income would result from the application of the proportionate profits method. As long as an alternative avenue is open to the taxpayer, it appears that the regulations in this area will continue to be rigidly applied.

A-8.00 Natural Gas - First Use Tax

In Maryland v. Louisiana, a case of original jurisdiction, the United States Supreme Court held that Louisiana’s “first use tax” was unconstitutional. The “first use tax” imposed a tax on any natural gas coming into the state of Louisiana which had not been already subjected to a state or federal tax, and which was not ultimately consumed within the state itself. The tax is due after the first taxable “use” of the gas occurs in Louisiana.

The stated purpose of the tax was “to reimburse the people of Louisiana for damages to the State’s waterbottoms, barrier islands, and coastal areas resulting from the introduction of natural gas into Louisiana from areas not subject to state taxes as well as to compensate for the costs incurred by the State in protecting those resources.” This protection was seen as necessary to equalize competition between in-state produced natural gas and out-of-state gas, as well as to protect Louisiana’s natural resources.

In invalidating this statute, the Supreme Court held that the tax conflicted with federal regulations which control the sale and regulation of natural gas and it therefore violated the Supremacy clause of the United States Constitution. The Court further found that the tax discriminated against interstate commerce in favor of local commerce in violation of the Commerce clause. In a separate decision the Supreme Court ordered the State of Louisiana to refund all taxes collected by means of the “first use tax.”

89 LA. REV. STAT. ANN. §§ 1301-1351 (West Supp., 1980).
90 Id. at § 1305.
91 101 S. Ct. at 2121, paraphrasing LA. REV. STAT. ANN. § 1301(C) (West Supp. 1980).
93 101 S. Ct. at 2131-2132.
95 101 S. Ct. at 2136. In pertinent part, the Commerce Clause states: “The Congress shall have Power . . . [t]o regulate Commerce among the several States. Art. 1 § 8 cl.3.
A-9.00 Coal Severance Tax

In *Commonwealth Edison Co. v. Montana*, the Supreme Court held that Montana's severance tax on coal mined in the state does not violate the Supremacy or Commerce clauses of the United States Constitution. The tax was levied at various rates depending on the value, energy content, and method of extraction of the coal. The tax rates ranged to a maximum of thirty percent of the "contract sales price." Montana coal producers were joined by their out-of-state utility company clients in a state court action seeking refunds of severance taxes paid under protest. The trial court upheld the tax and the Montana Supreme Court affirmed that decision.

In holding that the state severance tax did not violate the Commerce clause, the United States Supreme Court stated that "the Montana tax must be evaluated under Complete Auto Transit's four-part test . . . . [whereby] a state tax does not offend the Commerce Clause if it 'is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by the State.'" Appellants did not dispute that the Montana tax met the first two parts of the Complete Auto Transit test; their argument was that the tax was invalid under the final two parts of the Complete Auto Transit test. Concerning the third part, the Court found that the tax did not discriminate against interstate commerce since the tax burden was "borne according to the amount of coal consumed and not according to any distinction between in-state and out-of-state consumers." Nor was the Montana tax found by the Court to be invalid under part four of the Complete Auto Transit test. Appellants argued that the tax burden borne by the out-of-state consumers of Montana coal was excessive and that the amount of money which Montana received in taxes far exceeded the value of the services provided to the coal mining industry. The Supreme Court rejected this argument and stated that the appellants had misunderstood the nature of the inquiry under the fourth prong of the Complete Auto Transit test. The correct test is not the amount of the tax or the value of the benefits allegedly bestowed as measured by the costs the State incurs on account of the taxpayer's activities. Rather, the proper test for the fourth part of Complete Auto Transit is that "the interstate business must have a substantial nexus with the State before any tax may be levied on

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98 U.S. CONST. art. VI., cl.2.
99 U.S. CONST. art. I, § 8, cl.3.
101 615 P.2d 847 (Mont. 1980).
103 101 S. Ct. at 2954-55.
104 Id. at 2958.
it . . . [and] the measure of the tax must be reasonably related to the extent of the contact [with the state], since it is the activities of presence of the taxpayer in the State that may properly be made to bear a 'just share of state tax burden.'”

The appellant’s Supremacy clause argument was also rejected by the Court. Appellants argued that the Montana tax, as applied to the mining of federally owned coal, was invalid because it substantially frustrated the purposes of the Mineral Lands Leasing Act of 1920. The Court found that there is no language in the federal statute which promotes the use of coal, that supports the appellants assertion that Congress intended to “capture all ‘economic rents’ from the mining of federal coal and then . . . distribute the proceeds in accordance with a statutory formula.” Finally, the Court noted that Congress expressly authorized the states to impose taxes on federal lessees. Therefore, it appears that as long as states meet the Complete Auto Transit test, they are free to implement a coal severance tax.

B. Recent Developments

B-1.00 Income

B-1.01 Distortion of Income

The U. S. District Court in Nebraska held, in McGee v. United States, that absent proof of distortion of income to avoid taxation, the IRS may not allocate income under Code section 482.

McGee, a physician, entered into a personal services contract with a hospital to take charge of its emergency room. Later, the doctor-taxpayer formed a corporation and assigned his contractual rights with the hospital to the corporation. McGee reported $10,334 to the IRS as an independent contractor and the corporation reported $51,666 of the $62,000 paid under the personal services contract. The IRS contended that the corporation was a sham and invoked section 482 to allocate the total $62,000 as income to the doctor-taxpayer.

The court found the corporation to be a valid entity properly incorporated under the laws of the state. Therefore, the use of section 482 was found to be inapplicable “because there was no distortion of income to avoid taxation.”

If the IRS had been successful in its attempt to allocate the corporation's income to the doctor-taxpayer, the full amount would have been

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105 Id.
107 101 S. Ct. at 2961.
108 Id. at 2962.
109 81-1 U.S. Tax Cas. (CCH) ¶ 9184 at (D. Neb. 1980).
110 Id.
taxable to the doctor. But in this case, a valid, viable corporation protected the taxpayer from the IRS's attempt to allocate the income.

B-1.02 Interest Free Loans

Adhering to the principle of stare decisis, the Tax Court in Baker v. Commissioner\(^{111}\) held that the taxpayer did not realize taxable income from interest-free loans received from a corporation of which he was both president and shareholder. Even though the taxpayer owned tax-exempt securities at the same time, it was shown that the loans had not been used to make the securities purchases.

Mr. Baker, for the three years in question, used a running loan account from his closely held corporation to make his estimated tax payments. "There were no votes, no specific plan of repayment, and no interest was charged or paid. During 1973, Mr. Baker made monthly repayments in amounts of $1,000 to $3,000. In 1974, he made one payment of $50,000 and made no repayments during 1975."\(^{112}\)

Mr. Baker began the period in question as owner of $129,000 worth of tax-exempts and invested $45,000 per year for each of the successive years. According to the Tax Court, "the record does not show any correlation in time or otherwise between corporation loans and the investments in the tax-exempt securities. Accordingly, it does not appear that such loan indebtedness was incurred or continued to carry or purchase tax-exempt securities within section 265(2)."\(^{113}\)

Although the court admitted that this section could be read so as to cover this particular situation, the courts have required more than the simultaneous existence of ownership of tax-exempts and indebtedness.\(^{114}\) There must be "a 'purposeful connection' between the taxpayer's indebtedness and the ownership of the tax-exempt obligations."\(^{115}\)

The IRS will undoubtedly contest this opinion since it reaffirmed the Dean\(^{116}\) decision which it has been attempting to have overruled since 1973. In Dean, the taxpayers borrowed two million dollars interest-free from a corporation they controlled. No income was attributed to them for the free use of this money based on the reasoning that an offsetting deduction would have been available to them if interest had, in fact, been paid.\(^{117}\) Even

\(^{112}\) Id.
\(^{113}\) Id. at 95. This section states that no deduction shall be allowed for "[I]nterest on indebtedness incurred or continued to purchase or carry obligations the interest of which is wholly exempt from taxes imposed." I.R.C. § 265(2) (emphasis added).
\(^{114}\) Id. citing Swenson Land & Cattle Co. v. Commissioner, 64 T.C. 686, 695 (1975), and New Mexico Bancorporation v. Commissioner, 74 T.C. 1342, 1353 (1980).
\(^{116}\) Dean v. Commissioner, 35 T.C. 1083 (1961).
\(^{117}\) Id. at 1090.
though the IRS has attacked this holding in later cases, the courts have actually widened the number of situations in which interest-free loans may not produce realized income.

In Crown v. Commissioner,\(^ {118}\) the court held that a gift tax need not be levied on the amount of foregone interest when a loan, payable on demand, was made from a parent to a child.

In Joseph Lupowitz Sons, Inc. v. Commissioner,\(^ {119}\) the transfer of funds without interest, between corporations owned by the same persons did not result in a constructive dividend to the shareholders. This was held because none of the funds were used for the benefit of the taxpayer even though there was no specific business purpose for the loans.

In Zager v. Commissioner,\(^ {120}\) the IRS made a direct attack on the Dean holding because the fact situation was basically the same. The Tax Court, however, refused to find that income was realized from interest-free loans. The Court could not accept the government's reasoning as sufficient to overturn “prior practice (that) spanned a period of 60 years - from 1913 to 1973 . . . . Too much water has passed over the dam to warrant reexamining the situation judicially . . . . [I]f a contrary result is deemed desirable, the appropriate remedy should be legislative rather than judicial.”\(^ {121}\)

The court again followed Dean in Greenspun v. Commissioner.\(^ {122}\) In this case Mr. Greenspun was granted a $4,000,000 loan at 3% interest by Howard Hughes in return for favorable treatment of Mr. Hughes in Mr. Greenspun's newspaper. The court reasoned that if the difference between the interest charged and market rates was calculated as compensation, Mr. Greenspun would also have had a corresponding interest deduction, resulting in a wash out. Therefore, the court held that Greenspun had no taxable income as a result of the transaction.\(^ {123}\)

In both the Zager and Greenspun decisions, reference was made to the possibility that a different result might occur “if the indebtedness were incurred by the stockholder or officer to purchase or carry tax exempt bonds.”\(^ {124}\) The court in Greenspun stated that for the years in question “no

\(^{118}\) 585 F.2d 234 (7th Cir. 1978).

\(^{119}\) 497 F.2d 862 (3d Cir. 1974).

\(^{120}\) 72 T.C. 1009 (1979).

\(^{121}\) Id. at 1013.

\(^{122}\) 72 T.C. 931 (1979).

\(^{123}\) The Fourth Circuit Court of Appeals reached the same result based on Dean in Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980). The Fifth Circuit also followed this reasoning in Martin v. Commissioner, 649 F.2d 1133 (5th Cir. 1981), where a non-shareholder principal officer of a corporation was held to have no realized income as a result of interest-free loans made by the corporation.

portion of the loan proceeds was invested, partially or wholly, ... in
tax-exempt securities."

Based on this language, the holding in Baker was unexpected. Absent
congressional action on this matter, it would appear that interest-free loans
may be an avenue a closely held corporation may use to provide additional
benefits to officer-shareholders as well as children of shareholders. How-
ever, the practitioner should proceed cautiously, keeping in mind such
code traps as the accumulated earnings provisions, even though the
safe harbor here was increased to $250,000 by Congress in the Economic
Recovery Act of 1981. Taxpayers should also be careful to make the loan
payable on demand in order to avoid the pitfalls of gifts, as discussed in
Crown.

B-1.03 Relocation Service Fees

Recent letter rulings indicate that an employer may deduct certain
relocation expenses of transferring employees without the employees recog-
nizing income. Both letter rulings concerned an employer who contracted
with an employee relocation management company. The agreement stated
that the relocation company would purchase the homes of transferring em-
ployees at appraised values and then resell them within 360 days. The fees
paid by the employer include costs of appraisals; purchaser's fees; closing
costs; a percentage of any loss on the property's subsequent resale; carrying
costs including taxes, insurance, utilities, and monthly interest on the equity
advanced to the employee; and direct selling costs. The IRS ruled that
the employee must account for any gain realized on the sale of his house,
but that he would not have to include any of the above fees paid by his
employer in his gross income. The IRS further ruled that because the
payment of these relocation expenses bolsters the transferring employee's
morale thereby increasing productivity and efficiency, these expenses are
ordinary and necessary business expenses. Therefore, the employer may
deduct the payments to the relocation company. This plan would make
an excellent fringe benefit because if the employee pays his moving expenses
himself, his deduction is subject to the moving expense limitations.

B-1.04 Imputed Interest Rates

Under prior law, if property was sold under a deferred payment or
installment agreement, the IRS would impute a seven percent compounded
interest rate if the specified interest rate was less than six percent. Under

(Emphasis added).
126 I.R.C. §§ 531-61.
I.R.C. § 535(c)).
128 585 F.2d at 237.
130 Letter Ruling 8016098 (1980).
new regulations, the imputed interest rate is ten percent compounded semi-annually if the specified interest rate is less than nine percent simple interest. The new regulations are effective with respect to sales or exchanges occurring on or after July 1, 1981.

Also under prior law, if there were loans or advances between two or more related parties, IRS would impute the interest rates on these advances when the interest rates in the agreement were outside of the "safe haven" from six to eight percent. The new regulations change the safe haven range to eleven to thirteen percent and the imputed interest rate from seven percent to twelve percent. The new interest rates are effective with respect to loans or advances made on or after July 1, 1981. The new safe haven rule does not apply to loans or advances if the interest and principal are both stated in the agreement in the form of a foreign currency.

An exception to the above imputed interest rate changes is present in The Economic Recovery Tax Act of 1981, which provides that qualified sales of real estate will be subject to imputed interest rates of only seven percent. A qualified sale is any sale or exchange of land by an individual to a member of his family. However, aggregate qualified sales between any two individuals are limited to $500,000 annually. If a taxpayer desires to receive the lower imputed interest rate, he must sell his land to a family member for a price of $500,000 or less. Otherwise, the new higher interest rates will be imputed to the amount over the limit.

B-2.00 Deductions (Personal)
B-2.01 Home Office Expense

In Weightman v. Commissioner section 280A(c)(1) was interpreted so that the phrase "a portion of the dwelling unit," in reference to a deduction for a home office, may be satisfied without physical barriers or walls. College Professor Weightman took a home office deduction which was disallowed by the IRS on the basis that the taxpayer failed to show that the home office was maintained "for the convenience of his employer" as section 280A requires. The Tax Court affirmed this decision.

Taxpayer's home office consisted of a portion of his bedroom. The IRS urged an interpretation of section 280A(c)(1) that would require either "an entire room or some portion or area of a room physically separated." The court rejected this interpretation, choosing instead to hold that a "separate, though unmarked, area that [is] used exclusively and on a regular basis as [a] home office" complies with the statutory require-
ments. The court further stated that exclusiveness of use of an area is simply another fact for the trier of facts to determine. Physical barriers or lack of them is "a factor for the Court to weigh."\(^{140}\)

Although the court disallowed the home office deduction in this case, its interpretation of the phrase "a portion of a dwelling unit" in section 280A(c)(1) may be helpful to taxpayers in the future. The court said that evidence of exclusive use of unmarked areas would be viewed more critically but left the door open for a taxpayer to prove that such an area in a home was, in fact, used regularly and exclusively for the convenience of his employer.

B-2.02 Business Expense - Fashion Clothing

In *Pevsner v. Commissioner*\(^{141}\) the Fifth Circuit Court of Appeals disallowed a deduction for clothing as a business expense under sections 162 and 262 of the Code. This decision is clearly in line with the traditional interpretation of the nondeductibility of personal expenses.

Sandra Pevsner was employed as the manager of a boutique in Dallas which specialized in clothing design by Yves St. Laurent (YSL). Mrs. Pevsner was required by her employer to wear clothing by this designer in her work. However, because of store policy, she was not allowed to wear these items without purchasing them. Although these clothes were designed for ordinary use, Mrs. Pevsner's lifestyle was such that the clothing she was required to purchase was inappropriate for her off-duty hours. She therefore deducted the cost of the clothing on her tax return as a business expense.

The Tax Court\(^{142}\) allowed these deductions\(^{143}\) based on convincing evidence of Mrs. Pevsner's lifestyle and:

that the wearing of YSL apparel outside work would be inconsistent with that lifestyle; in such a situation the basis for allowing a deduction is far more persuasive than in a situation in which the clothes would be worn by a taxpayer outside his work but he merely, as a matter of personal taste, does not choose to wear such clothes when not at work.\(^{144}\)

In addition, the court mentioned that the financial burden which the taxpayer had to assume exceeded that which would ordinarily arise from the purchase of work clothes.

\(^{140}\) Id.

\(^{141}\) 628 F.2d 467 (5th Cir. 1980).


\(^{143}\) Pevsner v. Commissioner, 1979 T.C.M. (P-H) ¶ 79, 310 at 1164 (1979). The Tax Court relied on Yeomans v. Commissioner, 30 T.C. 757 (1958) where a similar clothing deduction was allowed. The IRS acquiesced in this decision (1959-1 C.B. 5) but withdrew its acquiescence after the *Pevsner* decision (1981-19 I.R.B. 5).

\(^{144}\) Id. at 1166 (emphasis added).
The court of appeals, however, reversed the Tax Court on the rationale that a fact as subjective as an individual's personal life style should not serve as the basis for allowing such a deduction. The court stated that:

The generally accepted rule governing the deductibility of clothing expenses is that the cost . . . is deductible as a business expense only if: (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing, and (3) it is not so worn.

The court reiterated the desirability of an objective rule which both the taxpayer and the IRS could utilize to make determinations as to deductions because the use of a subjective approach provides no guidelines. The court of appeals was convinced of the merits of an objective test because under a subjective standard the tax posture of two similarly situated boutique managers would vary on the basis of their individual lifestyles. The court viewed this result as an unreasonable interpretation of sections 162 and 262.

An attempt to circumvent the nondeductibility of clothing rule by means of leased suits received no support in Revenue Ruling 80-322. The IRS takes the position that the taxpayer must include in his gross income the fair market value of the suits leased to him. Where suits are custom tailored for employees and have little value at the end of the leasing period, a purchase rather than lease will be found for tax purposes. However, the corporate suit owner can receive a deduction for this amount as additional compensation.

B-2.03 Medical Expense - Tuition

As a result of the decision in Fay v. Commissioner, a taxpayer may deduct as a medical expense the additional cost of tuition charged for his children's participation in a language development program for the learning disabled. Two of the Fay children were found to have learning disabilities which prevented them from benefiting from a normal classroom situation. On the advice of their pediatrician, the Fays consulted specialists who recommended enrollment at a Montessori school which also provided a separate learning disabilities program.

The school the children attended did not qualify as a special school as defined by the tax regulations, since its main purpose was to provide an educational program, not to provide therapeutic treatment. Therefore, a deduction for the complete tuition was not allowed. However, the learning disabilities program was classified as one which "would alleviate or mitigate

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146 Pevsner v. Commissioner, 628 F.2d at 470.
147 Id. at 469 citing Donnelly v Commissioner, 262 F.2d 411, 412 (2d Cir. 1959).
148 Pevsner v. Commissioner, 628 F.2d at 470.
149 Id. at 471.
150 Id. 1980-2 C.B. 36.
the mental problems their children had. Since a fee for this was separately charged, that amount could be a medical deduction even though the staff providing the service was not medically trained.

Schools which provide such programs would be well advised to bill the clients separately for this service in order for the parents to benefit from this decision. It is also important that at some point a medical doctor state that a problem exists that can be alleviated through a special program.

B-2.04 Casualty Loss - Insurance

Prior case law held that insured casualty losses were not deductible if the taxpayer elected not to be reimbursed for the loss by the insurance company. Also, an employee could not deduct business expenses when he voluntarily chose not to seek reimbursement of those expenses from his employer. However, recent decisions have held that such losses or expenses may still be deductible.

In *Hills v. Commissioner*, the taxpayer’s house had been burglarized four times in an eight-year period. On the first three occasions, the taxpayer had been reimbursed by his insurer. However, the taxpayer made no insurance claim on the fourth burglary because he feared that his policy would not be renewed. Instead, he absorbed the loss and deducted it from his income. The IRS, in disallowing the deduction, argued that the taxpayer’s loss resulted from an election not to be reimbursed, and that, therefore, the loss did not result from the theft itself. The Tax Court disagreed and held that the IRS had unjustifiably expanded the meaning of “not compensated for by insurance” in section 165(a) to include potential recoupment, and that such an expanded definition would create an unjust advantage for voluntarily uninsured taxpayers. This decision was not unanimous, and the dissenting opinion was in agreement with the position of the IRS.

In *Waxler Towing Co., Inc. v. United States*, a marine towing business was required by contract with its customers to carry insurance. Its previous accident experience had been so poor that its prior underwriters had refused to renew coverage. When one of its barges was damaged in a collision, the company calculated that it would be less expensive to pay for the damage itself rather than make an insurance claim with the resulting higher premiums. When the company deducted the cost of repairs, the IRS disallowed it. The district court held that these costs were not deductible as casualty losses, citing *Kentucky Utilities Co., v. Glenn*. However, the

153 Kentucky Utilities Co. v. Glenn, 394 F.2d 631 (6th Cir. 1968).
156 Id. at 261.
157 Id. at 264.
159 394 F.2d 631.
court said that these costs were deductible as ordinary and necessary business expenses due to the necessity of remaining insurable.

In *Neal v. Commissioner*,' the taxpayer was the director of a financially troubled branch of the YMCA. In an austerity plan, he decided that employees would not be reimbursed for expenses incurred in the use of their personal automobiles for business purposes, despite a general YMCA policy to reimburse such expenses. When the taxpayer deducted his automobile expenses incurred for business purposes, the IRS disallowed the deduction. The Commissioner contended that because the taxpayer had the right and authority to demand reimbursement and had failed to do so, the expenses were not deductible. The Tax Court disagreed and held that if the taxpayer had demanded reimbursement he would have failed to meet a condition of his employment, which was to take steps to reduce the branch's expenditures. The court said that it was this unique set of facts that would make the expenses deductible.

The developing trend seems to be toward allowing deductions for reimbursable casualty losses or business expenses for which the taxpayer elects not to be reimbursed. However, these deductions may still be limited to the above situations.

B-2.05 Casualty Loss - Diamond Rings

In *Kielts v. Commissioner,* the Tax Court was confronted with the issue of whether the loss of a diamond from a ring caused by an unknown event was a deductible loss under Code section 165(c)(3). Taxpayers, Mr. and Mrs. Theodore Kielts, owned a 2.47 carat diamond mounted in a ring worn by Mrs. Kielts. Theodore Kielts cleaned the ring several times a year and at least every eighteen months had a jeweler check the mounting. One day as Mrs. Kielts was writing a check at the grocery store, the absence of the stone was noticed. Although she had seen the stone within the hour, an extensive search was unsuccessful. An examination of the mounting revealed two prongs missing and damage to the claws on the opposite side. However, Mrs. Kielts could not identify any specific event that might have so damaged her ring and caused the stone to be missing.

The Kielts claimed a casualty loss under section 165(c)(3). The Commissioner disallowed the loss stating that the taxpayer must be able to identify the event that caused the loss. The Commissioner relied on *White v. Commissioner* as a basis for claiming that the event causing the casualty must be identifiable.

In finding for the taxpayer, the Tax Court employed the doctrine of

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161 Id. at 557.
163 48 T.C. 430 (1967). In *White* a car door slammed on the taxpayer's hand and caused a diamond to be lost in a gravel driveway.
ejusdem generis to construe the phrase “other casualty” in section 165(c) (3). Early interpretations of this phrase required casualties similar in nature to fire, storm or shipwreck. In later decisions, however, the phrase was applied to “accidental losses caused by sudden and unexpected force.”

In Kielts, the Tax Court stated, “[i]t is not necessary to pinpoint the exact moment of the loss when, as here, some precipitating event must have occurred . . . .” The physical condition of the ring established that a forceful blow had taken place and that the specific event causing the damage was not identifiable was held not to be fatal to the taxpayer's deducted loss.

The Tax Court stated that “[t]he amount of deductible loss for a casualty is its adjusted basis, as determined under section 165 (b),” minus the $100 floor amount of section 165(c)(3).

B-2.06 Rental Property

The Tax Court, in Louise Hudson v. Commissioner, reviewed an IRS determination which resulted in the disallowance of deductions relating to rental property. Louise Hudson owned rental property in a declining neighborhood. Rather than rent to undesirable tenants, the taxpayer allowed a rental unit to remain vacant from September 1974, until January 1980, while she looked for acceptable tenants. During this period, the taxpayer continued to deduct depreciation, expenses, repairs, and a casualty loss. The IRS took the position that the excessive length of time that the rental unit remained vacant indicated a lack of a profit motive and, therefore, disqualified the taxpayer as a person carrying on a rental property trade or business as defined in section 162 of the Code.

In finding for the Commissioner, the court held that the taxpayer, indeed, had allowed the unit to remain vacant too long. Yet, the court gave no guidance as to precisely how long a rental unit could remain vacant and still qualify under section 162. In light of the fact that the taxpayer in this case was denied the deduction after a period of vacancy in excess of five years, taxpayers in a similar situation should take care not to allow their rental units to exceed, as a maximum, a five-year period of vacancy. However, under different circumstances, where taxpayer kept careful records and sought tenants, this time period could vary.

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164 I.R.C. § 165(c)(3) states that “[i]n the case of an individual, the deduction under subsection (a) shall be limited to . . . (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.” (Emphasis added).

165 Kielts v. Commissioner, 1981 T.C.M. (P-H) ¶ 81,329 at 1158 (citing White v. Commissioner, 48 T.C. 430 (1967) and Popa v. Commissioner, 73 T.C. 130 (1979)).

166 1981 T.C.M. (P-H) ¶ 81,329 at 1158.

167 Id. at 1159-60.


169 Id. at 562. Taxpayer's “shifting stories,” lack of substantiation on the claimed rental expense schedule and the failure to differentiate between the personal and business use of the duplex undoubtedly contributed to the court's finding a lack of a profit motive.

170 Id.
B-2.07 Medical Expense - Health Spa

The Code provides that an individual can deduct certain medical expenses paid during the year for himself, his spouse, and his dependents. As a condition to qualifying for the deduction, the taxpayer must not be reimbursed through insurance or otherwise.

In Keen v. Commissioner, the Tax Court allowed a medical expense deduction where the taxpayer installed a health spa in his home upon a doctor's advice. The purpose of the spa was to relieve the taxpayer's wife of severe arthritic pain.

The court allowed a deduction for the amount by which installation costs exceeded the amount by which the health spa increased the value of the taxpayer's residence. Based upon Rev. Rul. 67-76, the taxpayer should also be able to deduct maintenance and operating costs of the spa, as long as it is used for medical care.

B-2.08 Tax Shelter Advice

Ordinarily, attorney's or accountant's fees for tax advice to taxpayers are deductible. Recently the Tax Court held that costs and, in certain situations, advice for the acquisition of tax shelters must be capitalized as part of the cost of obtaining the shelter.

In Honodel v. Commissioner, taxpayers paid fees for periodic tax planning sessions in which their personal financial and tax status was reviewed and investment programs were proposed. The advisors would also study and select projects, negotiate the purchase of investments, and prepare the needed legal documentation, including a limited partnership agreement. The projects were then recommended to the taxpayers who had the option to invest in them.

The Tax Court found a "dual nature" in the advisor's function: "(1) an advisory function and (2) an acquisition function." The court held that the fees paid for the periodic advisory services were deductible. However, the court held that the fees paid for the acquisition of the tax shelters must be capitalized and that amount added to the basis of the investment. The court compared these fees to those of a stockbroker which also must be capitalized.

This holding is in agreement with an IRS Technical Advice Memorandum concerning a law firm which researched real estate syndications and offered to put its client in touch with the syndicators. Its fee included charges for modification of the partnership documents and research costs.

171 I.R.C. § 213. 172 Id.
176 Id. at 197.
177 Letter Ruling 8108008 (1980).
The position of the IRS was that these fees must be capitalized. The Memorandum cited Collins v. Commissioner,\(^{178}\) in which the Tax Court held that fees paid to an attorney who prepared a contract for purchase of real estate must be capitalized, but fees paid to a C.P.A. who restructured the terms in an attempt to have the down-payment classified as prepaid interest were deductible as tax advice.

A recent IRS Revenue Ruling\(^{179}\) is consistent with the above decision. In the ruling's fact situation, a tax advisor attempted to sell various interests in a limited partnership. The purchaser of the interest was given either a rebate from the partnership itself or a discount on the purchase price in an amount comparable to the tax advisor's fee. The IRS ruled that the purchaser could not deduct the payments made to the tax advisor because the limited partnership actually paid for the fees. Furthermore, the partnership could not amortize the payments under section 709(a) because payments were, in substance, "a commission for the sale of a partnership interest."\(^{180}\)

From this, one could extrapolate that a taxpayer may seek advice on his own tax shelter and the fees are deductible. However, if the advisor himself presents the shelter to a client, which he is organizing, the fee for this may need to be capitalized.

B-2.09 Commuting Expense

As a general rule the cost of travel between a taxpayer's residence and place of business is a nondeductible personal expense.\(^{181}\) However, where an employee is required by his employer to transport job-related tools or materials to and from work, a deductible expense is recognized to the extent extra cost is incurred above ordinary commuting costs.\(^{182}\)

In McCabe v. Commissioner,\(^{183}\) the Tax Court held that a policeman is not entitled to deduct extra transportation costs incurred because of the need to carry a revolver to work. The New York Police Department required all policemen to be armed when in the city. In order for McCabe to travel from his suburban residence to New York City on public transit, it was necessary that he travel through a portion of New Jersey. New Jersey law "permits officers employed by governmental agencies outside the state . . . to carry weapons in New Jersey only while engaged in official duties and upon prior notification to local police authorities."\(^{184}\) As a result, McCabe had to drive into the city. The policeman sought a deduction for the addi-

\(^{178}\) 54 T.C. 1656 (1970).
\(^{180}\) Id. at 8.
\(^{181}\) Rev. Rul. 56-25, 1956-1 C.B. 152.
\(^{184}\) Id.
tional commuting expenses incurred because he was precluded from utilizing public transportation.

In denying the deduction, the Tax Court held that the additional commuting expenses were incidentals of the policeman's occupation. The Court distinguished this case from the situation where a taxpayer is required by his employer to transport job-related tools to work regardless of where he lives. The distinction was made that it was the taxpayer's personal choice to live in an area where the most convenient route to his post was through New Jersey.\(^\text{185}\)

**B-3.00 Deductions (Business)**

**B-3.01 Noncompetition Agreement**

In *Kalamazoo Oil Co. v. Commissioner*,\(^\text{186}\) the taxpayer, a Michigan corporation, agreed to pay a retiring fifty percent shareholder $7,000 annually for life in exchange for the shareholders covenant not to compete. The shareholder, one of the original incorporators, had signed an agreement with the corporation whereby the corporation had an option to purchase five percent of his stock per year up to twenty-five percent. The remaining twenty-five percent of the shareholder's stock would be redeemed after death.

The Tax Court held that the covenant not to compete was a "paper promise" designed to provide the corporation with deductions for part of the cost of buying the shareholder's stock.\(^\text{187}\) Therefore, competition with the corporation by the shareholder was not in the shareholder's financial interest. The court further looked at the shareholder's age, 64, and the fact that he intended to and did, in fact, retire. The court noted the possibility of such a person competing with the corporation seemed very unlikely. Also, the life-long covenant to compete went beyond what might have been a reasonable time for competition, if the party involved had been a valid threat to competition. Therefore, the taxpayer corporation could not deduct as ordinary business the $7,000 annual payment to the shareholder under the guise of a covenant not to compete.

**B-3.02 Legal Fees**

Two 1981 Tax Court decisions dealt with the issue of when legal fees qualify as a permissible business deduction under the Code.\(^\text{188}\) As a general rule, legal fees expended by a corporation in successfully defending an employee against criminal charges based on corporate conduct are deductible business expenses.\(^\text{189}\)

\(^{185}\) Id. at 475.
\(^{187}\) Id. 1223.
\(^{188}\) I.R.C. § 162(a) (1976).
\(^{189}\) Union Investment Co. v. Commissioner, 21 T.C. 659 (1954),
In *Jack's Maintenance Contractors, Inc. v. Commissioner*, the Tax Court extended the general rule by holding that a corporation could deduct legal fees incurred in the defense of its sole shareholder-officer [hereinafter Jack Farmer] in a tax fraud proceeding which arose out of events alleged to have taken place before the business was incorporated. In characterizing the costs as ordinary and necessary business expenses, the court noted that the corporation's motive in paying the legal fees was to keep itself in business since Jack Farmer's services were "indispensable" and "irreplaceable."191

The Tax Court refused to apply the "origin of the claim test" which looks to the origin of the claim and determines whether it involved a personal or business activity or a capital transaction.192 The IRS contended that the litigation arose out of the business activities of Jack Farmer's sole proprietorship rather than the corporation's business and that therefore the origin of the claim prevented the deduction. The court rejected this argument stressing that the issue was not whether the legal expenses were deductible but by whom they were deductible.193 Even if Jack Farmer had been convicted of the criminal charges, his legal expenses should have been deductible. The Supreme Court has held that expenses of an unsuccessful criminal defense are deductible where the charges arose in connection with the taxpayer's trade or business.195

*Van Hafften v. Commissioner,* also decided by the Tax Court in 1981, held that legal costs expended to defend actions to compel sale of income producing property are not deductible. Mr. Van Hafften was sued for breach of contract and specific performance after negotiations broke down between himself and a prospective buyer of rental property. Legal fees in successfully defending the suit amounted to $14,000. Van Hafften argued that the legal fees were incurred for the protection of income producing property. The IRS contended that the legal fees were non-deductible costs to property and only increased the property's basis.

The Tax Court agreed with the IRS and held that amounts expended for legal fees were capital expenditures and as such could be added to the basis in the property. In doing so, the court applied the "origin of the claim test" and determined that the litigation "arose out of the disposition" of Van Hafften's property.197

190 1981 T.C.M. (P-H) ¶ 81,349 at 1235.
191 Id. at 1238.
192 Id. at 1237.
193 The "origin of the claim" test was developed in United States v. Gilmore, 372 U.S. 39 (1963), in order to determine whether a legal expense is deductible.
194 1981 T.C.M. (P-H) ¶ 81,349 at 1237 (emphasis added).
197 Id. at 450.
These cases make clear that the "origin of the claim" test is still viable. However, to achieve success, a taxpayer must do more than simply attribute the desired deduction\textsuperscript{198} to an income producing activity. The court will continue to look to the substance of the matter in making its decision.

**B.3.03 Ordinary Living Expenses**

The Tax Court decision in *Harrison v. Commissioner*\textsuperscript{199} should result in new tax planning measures being taken for the benefit of farmer shareholders and professional corporations through the application of section 119 of the Code. Under section 119, the value of meals and lodging which are provided to an employee will not be taxable to the employee provided that the meals and lodging are furnished for the "convenience of the employer."\textsuperscript{200} The *Harrison* decision\textsuperscript{201} indicates that ordinary living costs related to those meals and lodging may be deductible as ordinary and necessary business expenses.\textsuperscript{202}

Harrison Farms, Ltd. (HFL) was formed by two families who incorporated their grain and dairy operations. The families both controlled all the stock and were employees of HFL. Due to the nature of the operation and its need for round-the-clock supervision, the families were required to live and eat on the farm. Utility and telephone bills of the employees were paid by the corporation as well as costs for meals. HFL deducted the costs of the above items, and the Harrisons utilized section 119 to avoid being taxed on the value of the meals and utility payments.

The IRS challenged the section 119 exclusions characterizing the meals and payments received by the Harrisons as dividends. The deductions taken by HFL were attacked as outside the scope of ordinary and necessary business expenses and therefore impermissible. The Tax Court held, however, that since the Harrisons' presence on the farm was required at all times in order to conduct HFL's business, the cost of the meals and utilities were ordinary and necessary expenses of the corporation. The telephone expenses were treated as nondeductible dividends but the court said this was due to the fact that HFL presented no evidence as to the actual use of the telephone "nor was any allocation presented as to business use and personal use."\textsuperscript{203}

With regard to the exclusions taken by the Harrisons, the Tax Court stated that it was "clearly the duty of [the wives of the families] as corporate employees to obtain the food and prepare and serve meals which HFL provided all of its employees."\textsuperscript{204} The fact that the Harrisons were needed on the farm on a 24-hour basis in order to conduct corporate business indicated that the meals and lodging were furnished for the convenience of HFL.

\textsuperscript{198}I.R.C. § 162(a) (1976).
\textsuperscript{199}1981 T.C.M. (P-H) ¶ 81,211 at 691.
\textsuperscript{200}I.R.C. § 119(a) (1980).
\textsuperscript{201}1981 T.C.M. (P-H) ¶ 81,211 at 698-99.
\textsuperscript{202}I.R.C. § 162.
\textsuperscript{203}1981 T.C.M. (P-H) ¶ 81,211 at 699.
\textsuperscript{204}Id. at 697.
and that the Harrisons were required to lodge at the farm as a condition of employment. In effect, for purposes of the section 119 exclusion, the corporation provided the meals, and the utility expenses were considered a facet of lodging in that they were necessary to make the employees' homes habitable.

The significance of Harrison lies in its potential application to other corporations whose business does not fit a nine-to-five schedule. This decision should certainly stimulate other farm families to adopt a corporate form if for no other reason than to obtain these deductions for living expenses. It is doubtful, however, whether a professional corporation, performing legal or medical services, could use the same reasoning.

B-3.04 Interest - Business Purpose

The IRS has ruled that a corporation cannot deduct the ratable share of the original issue discount on a fifty-year note when the agreement required a deposit with the lender of 150% of the loan for twenty years.\(^5\) Under the agreement, the corporation issued a note for $20,000 to the lender and included with the note a deposit of $30,000 which was to be returned in twenty years. The note carried a 1.167% interest rate to be compounded monthly and was callable every two years. The financial plan was to deduct the total interest expense of $21,083,425 ratably over the fifty-year period, giving the corporation an annual interest deduction of $421,668.50. However, the IRS ruled that because of the large deposit there was no valid indebtedness as required by the rule of Knetsck v. Commissioner."\(^6\) In addition, an interest deduction was not allowed where there was no substance or purpose behind the transaction except the desire to obtain the tax benefit of an interest deduction.\(^7\)

Another financial plan covered by the revenue ruling was for the corporation to pay for tax planning advice in equal amounts of cash and long-term indebtedness.\(^8\) Under this plan the corporation paid $20,000 cash and issued a fifty-year note for $20,000, which had terms identical to the note above. The IRS ruled that a business performing services would not ordinarily accept a fifty-year note as payment and the sole purpose of the plan was to create interest deductions in excess of what was actually paid. The ratable interest expense was therefore found not deductible, limiting the deduction to the amount of cash actually paid for the tax-planning advice.

B-4.00 Exemptions

B-4.01 Marriage Penalty Tax

In an attempt to focus attention on the inequities of the tax rates for

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\(^{6}\) 364 U.S. 361 (1960).

\(^{7}\) Rev. Rul. 81-149, 1981-21 I.R.B. at 5 (citing Goldstein v. Commissioner, 364 F.2d 734, 741-42 (2d Cir. 1966) as the source of the rule that prevents a deduction in this situation).

jointly filing taxpayers where both parties are employed, David and Angela Boyter participated in annual divorces and remarriages. However, the Tax Court effectively blocked this method of circumventing the payment of additional tax in *Boyter v. Commissioner.*

Mr. and Mrs. Boyter, residents of Maryland, filed joint returns from when they were married in 1966 through 1974. Upon discovery that their tax rate would be lower if each filed as a single person, the Boyters determined to obtain a year-end divorce in a foreign country. In December, 1975, Mrs. Boyter, appearing personally, obtained a Haitian divorce. Mr. Boyter, through a Haitian attorney, filed a submission to Haitian jurisdiction. In January, 1976, the Boyters remarried in Maryland. The following November, Mr. Boyter, appearing personally, and his wife, by attorney, received a divorce in the Dominican Republic. In February of 1977, a Maryland marriage certificate was issued to the parties. The Boyters continued to live together during this entire period. In both 1975 and 1976, they filed and paid their taxes based on their status as single persons.

The IRS objected to this procedure, stating that the divorces were mere sham transactions designed only to avoid taxes. The matter was taken to the Tax Court where the issue was whether the Boyters were entitled to file as single individuals, i.e. whether the divorces granted by Haiti and the Dominican Republic were entitled to recognition by the IRS.

The court began its analysis by conceding that "for Federal income tax purposes, the determination of the marital status of the parties must be made in accordance with the law of the state of their domicile."[211] This is in keeping with the long held tradition that domestic relations are a "virtually exclusive province of the States."[212] However, since Maryland courts have never ruled on the question of the validity of foreign divorces, the Tax Court found it necessary to determine how that state's highest court would have ruled if it had been presented with the question.[213]

The court recognized the rule that "the domicile of at least one of the spouses is necessary in order for a divorce decree rendered by one state of our Federal system to be accorded compulsory recognition by all of the other states under the Full Faith and Credit Clause."[214] The court found that for recognition of the validity of a foreign[218] divorce under the principles of comity, the minimum requirement is that at the time it is awarded at

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211 Id. at 539.
212 Id. citing Sosna v. Iowa, 419 U.S. 393, 404 (1975).
218 Foreign in this context refers to outside the country.
least one of the parties must be a domiciliary of that country.²¹⁶ This was not the case here. As was openly stated during the foreign proceedings, both Mr. and Mrs. Boyter, at all times, were domiciled in Maryland.

Boyters argued that the IRS "should not be allowed to attack the validity of the foreign divorces in Tax Court because such an attack is proper only where there are conflicting judicial decrees regarding the taxpayers' marital status."²¹⁷ The court disagreed stating that since Congress set up different tax rates according to marital status, the IRS had both the right and the duty to determine that status. The court was convinced that Maryland, in spite of the participation of both parties, would not have recognized these divorces, and, therefore, that the taxpayers were not entitled to file as single individuals. This finding is clearly in accord with and strengthens past rulings.²¹⁸

One of the changes contained in the Economic Recovery Tax Act of 1981 somewhat reduces the tax burden on the two wage earner family by allowing a five percent deduction on the earnings of the lower paid spouse in 1982, and ten percent in subsequent years. This is to be an amount equal to the lesser of $3,000 or the qualified earned income of the lower paid spouse.²¹⁹ This will serve to aid some families but not those where both spouses are earning above average salaries.

B-5.00 Tax Credits
B-5.01 Investment Credit - Leases

In Loewen v. Commissioner,²²⁰ the Tax Court ruled that a change in business form from unincorporated to incorporated does not force a recapture of investment tax credit if substantially all assets necessary to operate the business are transferred to the corporation. Taxpayers George and Selma Loewen formed a corporation to which they transferred substantially all assets of their farming and cattle-feeding business. The real property and fixtures were leased and not transferred to the corporation. Prior to the incorporation, taxpayers had received investment tax credit under section 38. The Commissioner ruled the investment tax credit was subject to recapture under section 47.

In overruling the Commissioner, the Tax Court pointed to section 47(b) which exempts recapture if there is a "mere change in the form of conducting the trade or business..."²²¹ Further, the court looked to Regulation 1.47-3(f)(1) which sets out four conditions to be met for recapture

²¹⁷ Id.
²²¹ I.R.C. § 47(b).
exemption. The parties agreed that three of the conditions were met. In dispute was the fourth condition which states that it will be met if "(s)ubstantially all the assets . . . necessary to operate such trade or business are transferred. . . ." Substantially all the assets were transferred in this case and furthermore, the court noted, "special circumstances existed that prevented the transfer of the real property to the corporation.'

The court referred to the fact that the object of section 47 is to prevent a quick turnover of assets in an effort to receive multiple tax credits. This case presented no such danger because if the property were sold, recapture would then occur.

B-5.02 Investment Credit - Indefinite Lease with Option to Cancel

In Ridder v. Commissioner, the Tax Court held that taxpayer's open-end lease with options for either party to cancel, did not satisfy the requirements for an investment tax credit. Taxpayer, a noncorporate lessor, purchased a truck with a useful life of six years and thereafter claimed an investment credit based on the truck's status as section 38 property. The truck was immediately leased to taxpayers' employer and was destroyed in an accident just over one year later. The Tax Court disallowed the investment tax credit under section 46(e)(3)(B) because the lease term was more than fifty percent of the truck's useful life. That section allows such a deduction only if "the term of the lease (taking into account options to renew) is less than fifty percent of the useful life of the property.'

The taxpayer contended the term of the lease was controlled by the actual time of the truck's existence and therefore use. The Commissioner and the Tax Court said that the language of the lease must control. The language of the lease showed an intention for the lease to run for the truck's useful life, with options for either party to cancel. Absent a specification that the lease would end in three years, options to cancel the lease were insufficient to satisfy section 46(e)(3)(b)'s specific language that the lease must be for less than fifty percent of the property's useful life for an investment tax credit to be allowed.

Taxpayers should note that the useful lives of equipment have undergone a revision with the new tax Act. Under the new Act, the taxpayer's truck would probably be considered "5-year property" because it had a

224 76 Tax Ct. Rep. (P-H) Dec. ¶ 76.5 at 50, n. 2. The court was referring to the Kansas restriction regarding corporate ownership of farm land.
225 Id. at 50.
230 Id. § 201(c)(2)(B).
present class life of six years.\textsuperscript{231} If a truck is 5-year property by reason of the new Act, to qualify for the investment tax credit under the Ridder decision, a lease should specify a term of less than 21/2 years, \textit{i.e.}, less than fifty percent of its useful life.

\textbf{B-5.03 Investment Credit - Landlord/Tenant}

There is a specific restriction in the Code that "property which is used predominantly to furnish lodging . . . shall not be treated as section 38 property."\textsuperscript{232} The effect of this restriction is that the investment credit normally available for depreciable property is not allowed for property used in this manner. The IRS issued a new revenue ruling\textsuperscript{233} clarifying this in regard to a person whose business is the leasing of furniture. Under the new ruling, when furniture is leased to owners of a building who use the furniture for short term tenancies, the credit is not allowed. However, if the lessor leases directly to the tenants, he qualifies for the credit. The rationale for allowing the tax credit for furniture in this case was that "tenants do not \textit{furnish} lodging to themselves"\textsuperscript{234} within the meaning of the Code. This ruling revoked an earlier ruling\textsuperscript{235} which disallowed the investment credit in either situation.

Persons in the business of leasing furniture should weigh the advantages of gaining the credit by leasing directly to the tenant with the benefit of leasing to a potentially more financially responsible apartment corporation.

\textbf{B-6.00 Depreciation - Depletion}

\textbf{B-6.01 Oil/Gas Depletion - Bonus}

According to two recent Tax Court holdings, a taxpayer must have received the income from an actually producing oil or gas well in order to take a percentage depletion allowance deduction against gross income. In \textit{Engle v. Commissioner},\textsuperscript{236} the taxpayer claimed a depletion allowance against advance royalties he had received from the assignment of two oil and gas wells. The court stated:

Prior to 1975, it was well settled that the recipient of advance royalties (\textit{i.e.}, royalties paid in advance of the actual production of a mineral) under an oil and gas lease was entitled to compute depletion on the basis of both the cost method and the percentage method and to deduct the greater of the two amounts. . . \textsuperscript{237}

However, the court explained that the Tax Reduction Act of 1975\textsuperscript{238} added

\textsuperscript{231} The Asset Depreciation Range (A.D.R.) tables show a range of five to seven years for the present class life of a \textit{heavy} truck. A \textit{light} truck is given a present class life of three to five years and could therefore be considered "3 year property." \textit{Id.} § 201(c)(2)(A)(i).

\textsuperscript{232} I.R.C. § 48(a)(3).


\textsuperscript{234} \textit{Id.} (emphasis in original).


\textsuperscript{237} \textit{Id.} at 494.

\textsuperscript{238} Pub. L. No. 94-12, 89 Stat. 26.
section 613A to the Code which eliminated percentage depletion except for independent producers in certain specified instances. The amount of the permitted allowance was tied to the “average daily production” of the well, and formula for measuring the amount was included.239

In *Engle*, there was no production and the court reasoned that the exception was therefore not applicable. However, the taxpayer was still found eligible to deduct cost depletion. The court stated “[i]n our view, the fact that section 613A(c) was written into the Internal Revenue Code as a limited exception to the general repeal of percentage depletion for oil and gas militates against giving that section an expansive and extraordinary interpretation.”240

Using the same rationale, the court found in *Glass v. Commissioner*,241 that no percentage depletion deduction should be allowed for the amounts received by taxpayer as a bonus for giving the right to explore for oil and gas on his property. Again, however, these payments were available for a deduction figured on the cost depletion method. The court said the reason for this was because “the bonus payments are paid and retained, regardless of whether oil or gas is found.”242

Again, the court said actual production had to be present to permit percentage depletion. Since the statute’s formula for determining the allowable amount varies depending on the mineral found and other factors, there would be no practical method to ascertain the appropriate mode before production.

One of the purposes of the depletion allowance is to encourage exploration and exploitation of energy resources. However, since it is indirectly the American taxpayer who is subsidizing this effort, and since there have been abuses in the past creating political furor, the court is wise to read the statute as strictly as it has and to require actual production.

B-6.02 Depreciation - Avocado Trees

Avocado trees, like income-producing citrus trees243 and seed timber,244 are now considered depreciable assets245 qualifying for an investment credit if the taxpayer can establish that the tree's useful life is more than three years. In a decision rendered in 1950, the Tax Court held that avocado trees were not subject to depreciation because they have an indeterminate productive life.246 There was testimony in the 1950 case that avocado trees

239 I.R.C. § 613A(c).
242 Id. at 515 (quoting Burnet v. Harmel, 287 U.S. 103, 111 (1932)).
246 Krome v. Commissioner, T.C.M. (P-H) ¶ 50,064 at 159.
produce for two hundred years or more and that production increases as the trees mature. It was this factor which seemingly caused the IRS to state that the trees do not, therefore, depreciate in value.247

However, this was a memo decision rendered before the investment credit of section 38 was enacted. Subsequent revenue rulings248 have held that "citrus trees, trees of fruit orchards or groves, macadamia trees and trees of a seed orchard . . . are 'section 38' property. Since the definition of 'section 38 property' includes the requirement that a deduction for depreciation must be allowable with respect to the property,"249 it follows that the avocado trees may be depreciated. The useful life of the tree is measured from the point where the tree becomes income producing or when it first bears (fruit) in sufficient quantity to be harvested and marketed in the ordinary course of the taxpayer's business.250 This ruling attempts to end an artificial distinction between avocado and other fruit growers and to recognize the reality that avocado growers have been depreciating their trees over a twenty-year period.

B-7.00 Gains and Losses
B-7.01 Nonrecognition - Gold/Silver

Section 1031 provides that no gain or loss is recognized when property held for investment is exchanged solely for property of a like kind. Disputes over the application of section 1031(a)'s nonrecognition provision center on the definition of like kind exchange. The treasury regulations provide that "the words 'like kind,' as used in Section 1031(a) of the Code, have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not . . . be exchanged for property of a different kind or class."251

The Service held in Revenue Ruling 79-143252 that the exchange of United States twenty dollar collector gold coins (numismatic-type coins) for South African Krugerrand and gold coins (bullion-type coins) did not qualify as a like kind exchange. The IRS noted that the value of numismatic coins are determined by their age, number minted, and metal content, while the value of bullion coins is determined solely by its metal content. Numismatic coins represent an investment in the coins themselves while bullion coins represent an investment in gold on world markets. Following this reasoning, the Service concluded that the coins in question were not of the same nature or character, and therefore, were not property of a like kind.

247 Id. at 170.
251 Treas. Reg. § 1.1031(a)-1(b) (1965).
However, in a 1981 Letter Ruling, the IRS stated that the exchange of gold bullion bars for their dollar equivalent of the bullion-type South African Krugerrand gold coins constituted an exchange solely for property of like kind. Revenue Ruling 79-143 and this letter ruling can be distinguished by the fact that the latter involved only the exchange of bullion bars for bullion-type coins.

It can be seen from these rulings that the Service continues to stress the nature, character, or class of the property rather than its grade or quality in determining whether a transaction qualifies for nonrecognition of gain as a like kind exchange under section 1031.

B-8.00 Procedure
B-8.01 Tax Preparer Penalties

Understatement of a taxpayer's liability may subject preparers to two types of penalties. Negligent or intentional disregard of rules and regulations relevant to determining a taxpayer's correct tax liability subjects a preparer to a one-hundred dollar penalty. A five-hundred dollar penalty may be levied against a preparer for willful understatement of tax liability. These penalties are in addition to criminal penalties which may be applied for certain fraudulent acts. The treasury regulations state that a preparer has not negligently or intentionally disregarded a rule or regulation if he has exercised due diligence in an effort to apply the rules and regulations to the information given to him to determine a taxpayer's correct liability.

In a 1979 Letter Ruling, the IRS held that a preparer who failed to compute the minimum tax on certain tax preference items was subject to liability under section 6694(a). The burden of proof is on the preparer to show that he exercised due diligence in applying the rules and regulations to the information supplied by the taxpayer. However, "the Service must make an affirmative showing of the reason for which the penalty is asserted. It is not sufficient to merely find that the preparer has made a mistake."

Three criteria are used by the IRS to determine whether or not a penalty for tax preparer's negligence is warranted. These are set forth in Revenue Procedure 80-40. They are the nature of the error causing the understatement of tax, the frequency of errors and the materiality of errors. In reviewing the nature of the error causing the understatement of tax, the IRS will consider whether the misapplied provision was so complex or uncommon that the preparer might have reasonably applied it in an incorrect manner, and whether the preparer could have detected the error through a

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254 I.R.C. § 6694(a).
255 I.R.C. § 6694(b).
256 I.R.C. § 7206(2).
259 Letter Ruling 8001007.
general review of the return. In determining the materiality and frequency of errors, the IRS will penalize the preparer if a pattern of errors or an obvious error is found.

In light of Revenue Procedure 80-40, a preparer should consider developing a check list for his use to insure that nothing is overlooked. If a preparer can demonstrate that his office procedure is calculated to promote accurate returns, the IRS will be less likely to assert the penalty. If possible, prior returns of the taxpayer should be reviewed so that the preparer can be aware of possible problem areas.

The Code provides that a person is not an income tax return preparer if he merely furnishes typing, reproducing, or other mechanical assistance to a taxpayer. In light of this provision, an individual who owned a microcomputer and who intended to rent it to taxpayers, requested a ruling from the Service as to whether he would be an income tax return preparer under such circumstances. The computers were self-explanatory and informed the taxpayers how to make each entry in a Form 1040 or Form 1040A return.

The treasury regulations provide that a person who furnishes a taxpayer or another preparer sufficient information and advice so completion of a return is largely a mechanical or clerical matter is considered an income tax return preparer. Relying on the above regulation, the IRS held that the rental of the computers by the individual would qualify him as an income tax return preparer with respect to the returns made therefrom because "substantive decisions are made by you (the computer owner) when the computer indicates line by line what entries are to be made on the form."

An income tax preparer may be penalized one hundred dollars for each return which understates the tax liability of the taxpayer because of the preparer’s negligent or intentional disregard of tax rules or regulations. In Revenue Ruling 81-171 a taxpayer’s return indicated a net operating loss as a result of the preparer’s negligent or intentional overstatement of the taxpayer’s expenses. Based on the net operating loss carryback the preparer submitted amended returns for the years 1976, 1977, and 1978, and claimed refunds for those years. A second preparer prepared the taxpayer’s return for the following year and claimed a net operating loss carryforward. The second preparer was not aware of the first preparer’s overstatement of expenses and claimed the carryforward on the basis of in-

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261 Id.
262 Id.
267 I.R.C. § 6694(a).
formation presented to him by the taxpayer. The net operating loss deduction was a substantial portion of that return.

The IRS ruled that the Code's penalty for understating tax liability may be separately applied to other taxable year returns affected by the preparer's negligent or intentional disregard of rules and regulations. Therefore, the first preparer was subject to penalties for the negligent return, the three carryback returns, and the carryforward return. It was noted that if the IRS establishes willfulness on the part of the preparer, the five hundred dollar willful understatement penalty would apply to each return. The second preparer would not be subject to penalty.

Section 6695(f) imposes a five-hundred dollar penalty on an income tax preparer who endorses or otherwise negotiates a refund check issued to a taxpayer. Revenue Ruling 80-35\textsuperscript{269} represents a shift from the IRS position that the penalty extends to situations where a preparer negotiates a check under power of attorney or by reason of the taxpayer's endorsement. In a fact situation where a business manager-preparer requires each client to maintain a checking account over which he has a power of attorney to sign checks upon express authorization of the client, the IRS ruled that the preparer was not liable under 6695(f). It reasoned that it was the client rather than the business manager who negotiated the refund check since this could be done only as a result of the client's specific instruction.

As a protective measure, preparers who possess a power of attorney to endorse or negotiate a check should require a client to give written authorization to deposit the refund check at the moment the preparer endorses the check. In this manner, the issue of what constitutes "specific instructions to deposit a check" does not arise and section 6695(f) liability can be avoided.

Under each of the aforementioned penalties for understatement of a taxpayer's tax liability, if the understatement is the result of the actions of more than one preparer, then each preparer is subject to a separate penalty. However, where a preparer is penalized under either section 6694 or section 6695, his employer or the partnership of the preparer is not also subject to penalty unless the employer or partnership participated in the attempt to understate the tax.\textsuperscript{270}

B-8.02 Taxpayer Compliance Measurement Program - Audit

Two circuit courts have determined that taxpayers must comply with the IRS' Taxpayer Compliance Measurement Program (TCMP). In the recent case of United States v. First National Bank in Dallas,\textsuperscript{271} the Fifth Circuit Court agreed with the rationale of the Eighth Circuit in United

\textsuperscript{269} 1980-1 C.B. 305.


\textsuperscript{271} 635 F.2d 391 (5th Cir. 1981).
States v. Flagg and held that I.R.C. section 7602 expressly authorizes the IRS to issue summons.

First National Bank in Dallas was brought by the bank on behalf of one of their customers, James A. Yeoham, a physician. Dr. Yeoham had ordered his financial institutions not to comply with summons issued by IRS in furtherance of the TCMP. In reaching its decision, the Eighth Circuit court examined United States v. Flagg, which involved an attorney who objected to mandatory participation in the TCMP.

Both of these cases determined that the IRS has the right to issue summons for an ongoing investigation and that the purpose of that investigation may properly be data gathering for research. The IRS considers the objectives of TCMP to be research and data gathering based on the theory that this program highlights those areas of tax laws with which taxpayers are most likely to have difficulty. The two courts held that cooperation with the IRS's TCMP is not optional but mandatory and that the IRS has the statutory right to summon information for that program, even though the acknowledged goal of the TCMP is to obtain research data.

Taxpayers considering noncompliance with a TCMP audit should be forewarned that all district court decisions in their favor have now been overturned.

B-8.03 Release of IRS Internal Documents

In Taxation with Representation Fund v. Internal Revenue Service, the District Court for the District of Columbia gave the taxpayer greater access to IRS documents. The original complaint seeking access to the IRS records was filed by the Taxation With Representation Fund under the Freedom of Information Act. The Plaintiffs sought access to three types of records: IRS General Counsel's Memoranda, IRS Technical Memoranda and IRS Actions on Decisions. The IRS General Counsel's Memoranda were defined by the court to be:

Legal memoranda from the Office of Chief Counsel to the Internal Revenue Service prepared in response to a formal request for legal advice from the Assistant Commissioner (Technical). G.C.M.'s are primarily prepared by attorneys in the Interpretative Division of the Office of Chief Counsel and usually addressed to the Office of the Assistant Commissioner (Technical) in connection with the review of proposed private letter rulings, proposed technical advice memorandum, and proposed revenue ruling of the IRS.
The G.C.M.'s include a lengthy legal analysis of issues presented as well as recommendations based upon the analysis. The second type of record sought is known as the IRS Actions on Decisions. A.O.D.'s are:

prepared . . . whenever the government loses an issue in a tax case either in Tax Court or in a federal district court . . . . [T]he A.O.D. sets forth the issue which was decided against the government, a brief discussion of the facts and reasoning of the attorney behind his or her recommendation that the Commissioner either acquiesce or non-acquiesce in a decision of the Tax Court or of the federal district court.279

The final type of record sought was the IRS Technical Memoranda. These are prepared in connection with a proposed treasury decision. The T.M.:

summarizes or explains the proposed rules provides background information, states the issues involved, identifies any controversial legal or policy questions, discusses the approach taken by the draftsperson, and gives the reasons for the approach.

T.M.'s are indexed, digested, and made available to IRS personnel in order to assure consistent treatment of taxpayers.280

The district court cited two decisions as compelling disclosure of these documents. Pies v. Internal Revenue Service,281 required disclosure of Technical Memoranda because they were used as a formal statement on the part of the IRS. The court extended this reasoning to the General Counsel Memoranda and the Actions on Decisions noting that when such a use is made of these records, they cannot be exempted from disclosure under the Freedom of Information Act. A second case, Falcone v. Internal Revenue Service,282 held that the General Counsel Memoranda were not exempt from disclosure since they “state current agency interpretations and note where the proposed ruling may differ.”283 A final factor noted by the district court in favor of disclosure, was the finding that none of the three types of records in question were protected by the attorney-client privilege, nor where they a result of work product.284

The holding by the district court may prove very helpful to taxpayers and their counsel. This is evidenced by the great amount of tax knowledge made available to the public since 1977 by the release of private letter rulings. However with the passage of section 701 of the Economic Recovery Act of 1981 which allows the Secretary to withhold audit standard information, it may be that disclosures by the IRS are over.285

279 Id. at 266-67.
280 Id. at 267.
283 Id. at 988.
284 485 F. Supp. at 268.
B-9.00 Pension Profit Sharing and Stock Ownership Plans

B-9.01 Professional Corporation - Pension

Previous decisions of the Tax Court held that two professional corporations which formed a fifty-fifty partnership did not have to cover the partnership's employees under either of the corporations' pension plans because neither corporation controlled the partnership. The court held that the exclusive test for determining whether employees of affiliated entities should be aggregated under the anti-discrimination provisions is the common control test under section 414(b) and (c). This test requires that a partner hold a greater than fifty percent interest in the partnership to be considered in control.

However, Congress recently enacted a new law which requires that employees of the members of an affiliated service group shall be treated as employed by a single employer. An affiliated service group is defined as an organization plus one or more of the following:

1. any service organization which is a shareholder or partner in the above organization and regularly performs services for or with the above organization, and

2. any other organization if a significant portion of its business is the performance of services for any of the above organizations which would normally be performed by their own employees, and ten percent or more of the interest of this organization is held by officers, highly compensated employees, or owners of the above organizations.

A recent revenue ruling gives some examples of the application of the above tests while rendering the two earlier rulings obsolete. In one example corporation S is owned by professional corporations A, owning eleven percent, and B, owning eight percent. S provides secretarial services performing one-third for each of A, B and third persons. A and B have retirement plans which cover only their own employees. Under prior law, neither A nor B would have to include S's employees in their retirement plans because neither has control of S. Under the new law, A and S meet the requirements to be classified as an affiliated service group because A owns more than ten percent of S which has as a significant portion of its business the performance of services for A. B, on the other hand, is not included in

288 I.R.C. § 414(b), (c) (1978).
289 Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 201, 94 Stat. 3521 (adding I.R.C. § 414(m)).
290 I.R.C. § 414(m)(2)(A) & (B).
the affiliated service group because it has a less than ten percent interest in S. With the control test reduced to ten percent, most organizations will not be able to eliminate rank and file employees from pension coverage unless they have a large group of shareholders or partners.

B-9.02 Professional Corporation - Stock Bonus Plan

Section 401(a) of the Code sets out the requirements for tax qualified pension, profit sharing and stock bonus plans. One of these requirements is that the plan be set up so as not to discriminate in favor of certain employees who are shareholders, officers or highly compensated employees of the corporation. In the case of Ralph Gano Miller v. Commissioner, the Tax Court examined the stock bonus plan of a professional law corporation to determine whether it met this requirement.

The taxpayer's stock bonus plan provided for distribution of the corporation's stock only to a "licensed person under the provision of section 13406 of the California Corporations Code." Those non-licensed employees' benefits were to be "distributed in cash, or other assets in kind, provided no discrimination in value results therefrom.

The court first turned to the Treasury Regulations in order to determine the exact nature of a stock bonus plan and the extent to which it was subject to the requirements of section 401 of the Internal Revenue Code. The court concluded that all benefits under the stock bonus plan must be distributed as "stock of the employer company." Thus, this plan which provided for distribution of assets other than stock did not meet the literal requirement of the Treasury Regulation definition.

Second, the court noted that a plan such as the taxpayer's might allow for discrimination against non-licensed employees. Congress had required that plans be non-discriminatory and the court found the plan used in the Miller case to be in conflict with that intent. The court noted:

Requiring stock bonus plans to distribute benefits in the form of employer bonus stock appears to be a reasonable means of avoiding the opportunity for manipulation or discrimination with respect to the distribution of plan benefits. Put more simply, the requirement

295 Id. at 233.
296 Id.
297 Treas. Reg. § 1.401-1(b)(1)(iii) (1960) reads:
A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan. (Emphasis added).
to distribute benefits in the form of employee stock is the seal which makes the employee's benefit airtight.\textsuperscript{299}

The conclusion reached by the court was that the congressional intent of section 401 required that stock of the employer be the only property to be distributed to all qualified employees in order for a non-discriminatory stock bonus plan to exist.

B-9.03 Partnerships - Keogh Deductions

The Tax Court in \textit{Arkin v. Commissioner}\textsuperscript{300} decided that since the Keogh deductions limitation is determined on the partnership level and not the partner level, a partnership may under certain circumstances have two fiscal years and a partner may receive two deductions in one income tax return.

In \textit{Arkin}, the law partnership had a normal fiscal year ending on March 31st. On December 31, 1975 the partnership was terminated. The partner/taxpayer deducted $7,500 for the contribution made by the partnership for the first taxable year, up to March 31st. In its fiscal year ending on December 31st, the partnership again contributed the maximum of $7,500 then allowed under a Keogh plan, which the partner/taxpayer also deducted. The taxpayer was allowed this $15,000 Keogh deduction by the Tax Court.

The court decided that limitation on deductible amounts applies not to the individual/taxpayer but to the partnership. Under the treasury regulations for section 404(e) the amount deductible depends on the taxable year of the employer.\textsuperscript{301} Based upon another regulation, an employer clearly includes a partnership.\textsuperscript{302} The court reasoned that in this case, there were two fiscal years for the partnership even though the same partner received, in effect, a double deduction.

Whether this decision will be extended to a change in form, such as a sole-proprietorship to a professional corporation, with a Keogh deduction followed by a corporate pension deduction, remains to be determined. Also, it is doubtful whether a court would uphold similar deductions where the Keogh employer had a history of terminations.

B-10.00 Corporations

B-10.01 Attribution - Family Hostility

The Tax Court ruled in \textit{Metzgar Trust v. Commissioner}\textsuperscript{303} that hostility among members of a family will not nullify the attribution rules of section 318. This decision conflicts with \textit{Haft Trust v. IRS}\textsuperscript{304} in which the First

\textsuperscript{299} \textit{Id.} at 235.
\textsuperscript{301} Treas. Reg. § 1.404(e)-1A(c) (1979).
\textsuperscript{302} Treas. Reg. § 1.404(e)-1A(f) (1979).
\textsuperscript{304} 510 F.2d 43 (1st Cir. 1975).
Circuit court held that the attribution rules may be disregarded if there is family hostility.

In *Haft Trust*, the First Circuit viewed the attribution rules as creating a presumption of continuing influence over corporate affairs. In that case, a corporation redeemed stock held in trust for a shareholder's children. This redemption followed a bitter divorce. The First Circuit ruled that because the continuing influence was not present, the distribution would not be treated as a dividend. The IRS subsequently issued Revenue Ruling 80-26\(^{305}\) stating it would not follow the *Haft Trust* decision.

In *Metzger Trust*,\(^{306}\) the Tax Court agreed with the Commissioner and held that the family attribution rules would still apply because the plain language of the statute made no exception for family hostility. The Tax Court noted that the legislative history clearly shows that Congress intended to provide precise standards whereby a taxpayer may be considered as owning stock. Therefore, the redemption distribution in this case was treated as a dividend.

**B-10.02 Reallocation - Evasion of Taxes**

Section 482 of the Code permits the income of certain trades and businesses to be reallocated by the Secretary in order to clearly reflect their true income. In *National Securities Corporation v. Commissioner*,\(^{307}\) the court examined the predecessor of this section and noted that it was:

directed to the correction of particular situations in which the strict application of the other provisions of the act will result in a distortion of the income of affiliated organizations. In every case in which the section is applied, its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act.\(^{308}\)

In *Ruddick Corp. v. United States*,\(^{309}\) a recent Court of Claims decision, however, it was determined that absent tax evasion or tax avoidance as a purpose of the taxpayer, section 482 could not be used to reallocate income. In *Ruddick*, the taxpayer was the parent of a stock brokerage firm, R. S. Dickerson and Co. (RSD), as the result of a corporate reorganization. Ruddco, Inc. was a wholly owned subsidiary of RSD and owned portfolio stock. Prior to the reorganization which created Ruddick, RSD directed Ruddco to distribute its portfolio stock to RSD as a dividend in kind.\(^{310}\) Following the reorganization, Ruddick “directed the sale to outsiders by RSD of the portfolio stock that had been distributed to RSD by Ruddco.”\(^{311}\) At the time the portfolio stock was sold, Ruddco was a prospering corporation to whom any gain from said sale would have been taxable income.

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\(^{305}\) 1980-1 C.B. 67.  
\(^{306}\) 76 Tax Ct. Rep. (P-H) Dec. ¶ 76.3 at 32.  
\(^{307}\) 137 F.2d 600 (3d Cir. 1943).  
\(^{308}\) Id. at 602.  
\(^{310}\) Id.  
\(^{311}\) Id.
RSD, on the other hand, had carried forward a large operating loss against which it applied the gain from the sale of stock. The government reallocated the gains so as to cause Ruddick, as RSD's parent and successor, to pay a tax deficiency.

While on its surface, this may seem to be the ideal situation for the application of section 482, the existence of one more factor was considered by the Court in disallowing the use of that section. That is, Ruddick needed the net capital the stock portfolio provided to satisfy the requirements of the Securities and Exchange Commission and Mid-West Stock Exchange. Since this business purpose was the motivating factor in the transfer of the stock, "the commissioner may not use his power of reallocation under § 482 to change or modify, on the ground of income distortion, a transaction that Congress has seen fit to authorize specifically in spite of the fact that transaction may well embody some sort of income distortion." This led to the final conclusion that some tax evasion purpose must be evident before the power granted by section 482 may be used.

B-10.03 Capitalization - Business Expansion

The Fourth Circuit held that intangible costs of expanding a business must be matched against the benefits derived and the year in which those benefits are derived will determine whether such costs are current expenses or future expenses which must be capitalized.

In *NCNB Corporation v. United States*, the taxpayer was a national bank, North Carolina National Bank (NCNB), which was involved in expanding its business by opening new branch banks. Various expenditures connected with expansion were under consideration by the court. Two of those expenditures were marketing studies the bank had prepared or purchased, to assist in deciding the locations of its contemplated new branches. The bank deducted the full amount of these studies as current expenses. The Commissioner claimed that these costs were associated with the production of future income and therefore must be deducted in the future. The district court's decision for the taxpayer was based on the fact that none of the expenditures under consideration created a "separate and distinct asset."

However, the circuit court insisted that an attempt must be made to match the expenditures against projected benefits. If those benefits could be realized in the current year, a current expense deduction, pro rata or fully, is allowable. But the court said, when benefits accrue in the future, the expenses must be matched with the future benefits, causing the expenses to be capitalized. In this way, the court maintained, current income can be more accurately reflected.

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812 Id.
813 651 F.2d 942 (4th Cir. 1981).
814 Id. at 947.
815 Id. at 962.
The vigorous and well-reasoned dissent by Judge Widener must be noted. Judge Widener quoted from Commissioner v. Lincoln Savings & Loan Ass'n., wherein the Supreme Court said, "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year."

Whether this Fourth Circuit opinion will be followed by the other circuits bears observation. The Fourth Circuit's insistence that expenditures be matched with anticipated benefits to determine in what year a deduction may be taken forces taxpayers in that circuit to make an allocation of current benefits and future benefits for tax deduction purposes.

B-10.04 Recapitalization Without Recognition of Gain or Loss

In a recent letter ruling, the IRS allowed tax-free treatment, without section 306 taint, for a corporate division outside of section 355 that coupled with a stock recapitalization not governed by section 368. In the factual situation given, Father, Mother, and Child, or A, B, and C respectively, owned all of the outstanding shares of Company. Because A wanted to transfer Company's businesses to his sons, it was proposed that each would be separated into a distinct corporation. However, one of the two manufacturing businesses operated by the Company had been in operation for less than five years so separation and recapitalization under sections 368 (a)(1)(D) and 355 was not possible.

Under the proposed plan, Company would change its name to Corporation with each share of Company stock automatically converting to Corporation common stock. Corporation would then organize X and Y. C would acquire, for cash, all of the shares of X common stock, and Corporation would transfer certain of its assets to X in exchange for X preferred stock. D (another child) would acquire all of the shares of Y common stock for cash, and Corporation would transfer the remainder of its assets to Y in exchange for Y preferred stock. Some preferred stock of both X and Y was to be held by Corporation under a contingency arrangement subject to a determination of the fair market value of the transferred assets. This would result in Corporation owning as its only assets all the preferred stock in both X and Y, with A, B, and C continuing to own all of Corporation's common stock. By prearrangement, C and D would then purchase

816 403 U.S. 345 (1971).
817 Id. at 354, quoted in instant case 651 F.2d at 964 (Widener J., dissenting). Lincoln Savings and Loan concerned a statutorily created reserve fund. Regulatory authorities mandated that the fund be treated as an asset.
820 Id. at 14.
821 Because the question was not raised, the IRS did not rule on corporation's status as a personal holding company.
A’s stock in Corporation over a period of fifteen years. In addition, A and B intend to make annual gifts to C and D of their shares in Corporation in amounts of $6,000 to each.

The IRS ruled that pursuant to section 351(a), no gain or loss would be recognized by Corporation, C, or D upon the transfers of property or cash to the new corporations in exchange for stock. The basis of the assets of X and Y would have the same basis as that of Corporation immediately before the exchange. Furthermore, none of the stock issued was to be classified section 303 stock. Representations by A, B and C upon which this ruling was based significantly include the conditions that Corporation X and Y not be liquidated, as a part of the transaction, and that none of Corporation’s transferred assets had been received in a tax-free transaction.

This ruling indicates that the IRS has relaxed its position on what will be classified as section 306 stock. In the past, any stock, preferred as to dividends and liquidations, could be classified as 306 stock. It now seems that the IRS will examine whether there is real potential for converting ordinary income into capital gains without dilution of control by the sale of dividend stock before so designating the stock. This is more in line with the original purpose of section 306 which was to prevent preferred stock bailouts.

B-10.05 Installment Obligation Exception

The Tax Court and the Tenth Circuit have held that although a taxpayer does not characterize certain transactions as installment obligations for section 453 income reporting purposes, this does not prevent the taxpayer from characterizing the same transactions as installment obligations in order to recognize a loss in a section 337 corporation liquidation. In Liberty National Bank and Trust Company v. Commissioner, the bank, acting in accordance with a trust agreement, liquidated an accrual basis corporation under section 337. The corporation’s accounts and notes receivable were sold at a $50,000.00 loss.

Section 337 generally provides for the nonrecognition of gain or loss to a corporation that distributes all of its assets during the twelve months after the start of its planned complete liquidation, with certain exceptions. One such exception which will result in the recognition of gain or loss concerns installment obligations. Under section 337(b)(1)(B) these are defined out of the term “property” for the non-recognition purposes of section 337(a).

The taxpayer trustee-bank in Liberty National Bank and Trust Com-

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822 This represents the amount a husband and wife could gift annually without gift tax consequences prior to the Economic Recovery Tax Act of 1981.
823 Metz and Yang, supra note 319, at 15.
824 1979 T.C.M. (P-H) ¶ 79.074 at 309, aff’d, 650 F.2d 1174 (10th Cir. 1981).
pany, deducted the $50,000.00 loss taken on its client's receivables. The Commissioner contended that since these receivables were not treated as installment obligations for income reporting purposes under section 453, the same transactions could not now be characterized as installment obligations for purposes of recognizing a deductible loss in a corporate liquidation. The Commissioner argued that bona fide installment obligations are "periodic payments spread out over a period of time, and reported in the manner permitted by section 453."

The Tax Court disagreed. In affirming that decision, the court pointed out that section 453 reporting is not mandatory, and as such a decision to refrain from characterizing installment obligations according to section 453 is not dispositive as to the existence of the obligations.

The fact that a taxpayer elects not to use the method of reporting permitted by section 453 does not necessarily mean that obligations in the form of trade accounts and notes receivable are not "installment obligations" as that term is used in section 337(b)(1)(B).

This decision places the Tenth Circuit in accord with earlier decisions of the Ninth Circuit. It seems that if the Commissioner wants section 453 reporting to be obligatory before section 337's exceptions may be used, some change in the current law is necessary.

B-10.06 Liquidation Reincorporation - Business Motive

Generally, capital gains treatment is available to shareholders who receive distributions in excess of their basis in the complete liquidation of a corporation. However, even if the transactions meet all of the requirements of section 337, the distributions may receive dividend treatment if substantially all of the assets of the transferee corporation are transferred to another corporation which is under the control of the same shareholders. The absence of a tax avoidance motive in the structure of the "liquidation" does not prevent the IRS from treating the transaction as a D reorganization per section 368 (a)(1)(D).

In *Atlas Tool Co. v. Commissioner*, the Third Circuit held that once the statutory tests of section 368(a)(1)(D) are met, the nonstatutory test does not focus on tax avoidance motive but rather on continuity of the business. The Ninth Circuit recently agreed with this holding in *Rose v. United States*. In this case, a husband and wife owned all of the capital stock of two corporations. One corporation adopted a plan to liquidate

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228 650 F.2d at 1177 (emphasis in original).
229 *Id.*
237 *Id.* at 1177-1178.
239 640 F.2d 1030 (9th Cir. 1981).
under Section 337 and transferred all of its assets except cash to the other controlled corporation. The cash was distributed to the shareholders who claimed capital gain treatment for this distribution under Section 331. However, the IRS contended that this transaction also satisfied the requirements of Section 368(a)(1)(D), and contended that the distribution was a dividend. The shareholders argued that because there was no tax avoidance motive, the transaction should be treated as a liquidation. The Ninth Circuit agreed with the IRS, holding that once a sale and liquidation meet the technical requirements of section 368(a)(1)(D), it can be reclassified as a D reorganization without proving a tax avoidance motive.

It is therefore essential that transactions be examined as a whole to see whether or not they may be classified as a reorganization as opposed to a liquidation. Sometimes it will be to the taxpayer’s advantage to establish that a reorganization has taken place, such as when the controlling shareholder is a corporation which would prefer dividend treatment of the distributions rather than a capital gains treatment.

B-10.07 Liquidation - Effect of Holidays on Nonrecognition Provision of Section 337

The Code provides that if a corporation adopts a plan of complete liquidation, and within twelve months thereof distributes all of its assets which are not retained to meet claims to its shareholders, then any profits on the sale of the corporation’s assets are not taxable to the corporation. The issue of whether or not a corporation is entitled to take advantage of this nonrecognition provision arises when the last day of the twelve-month period is a legal holiday or on a weekend. The Code states that any act is timely if the last day prescribed for accomplishing that act is a Saturday, Sunday or legal holiday and the act is performed on the following day. However, the IRS in Revenue Ruling 72-541 refused to extend the two-and-one-half month time period under section 267(a)(2) relating to unpaid expenses and interest with respect to transactions between related taxpayers to the Monday following the weekend which closed the time periods only in situations where an act is required by internal revenue law to be performed on or before a prescribed date or within a prescribed period. The IRS determined that the term “act” as it is used in the Code means “procedural steps in connection with the determination, collection or refund of taxes.”

In Atlee D. Snyder, the Tax Court examined committee reports and the statutory language relating to section 7503 and held that the IRS had construed section 7503 too narrowly in Revenue Ruling 72-541. The Court held that the twelve-month liquidation period referred to in section

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\[337(a) \text{ (1976).} \]
\[7503. \]
\[1972-2 \text{ C.B. 645.} \]
\[Id. at 646. \]
\[1981 \text{ T.C.M. (P-H) } \| 81,216 \text{ at } 722. \]
337 should be extended to the Monday following the end of the statutory period.

B-10.08 Preferred Stock - Section 306

Section 306 of the Internal Revenue Code was devised to eliminate preferred stock "bailout" situations. Prior to its enactment, when a corporation issued preferred stock as dividends two advantages inured to the shareholder. First, since the preferred stock carried no voting rights, its subsequent sale did not reduce the shareholder's interest in the growth of the corporation. Second, the proceeds of the sale were given the more favorable capital gain treatment rather than being subjected to the higher ordinary income tax rates given cash dividends. This "bailout" was also common when two classes of stock, one of which was non-voting preferred, were issued in a recapitalization of a corporation having earnings and profits. Under section 306, the proceeds from the sale of the preferred stock issued in both situations would generally be treated as common stock subject to ordinary income tax in order to prevent the draining off of earnings of the corporation with no proportionate reduction in the shareholder's interest in corporate growth.

What is "common stock" for purposes of section 306 is not stated in the Code. Revenue Ruling 81-91 broadens an earlier interpretation of what it encompasses. The IRS begins its analysis by viewing the newly issued stock of a corporation in terms of the "bailout" situation Congress meant to prevent by section 306. If the stock is "limited and . . . does not participate in corporate growth to any significant extent" then the stock is not common stock under section 306. Stock that in form is in a preferred position may still be deemed "common" under section 306 if it encompasses an interest in the unrestricted growth of the corporation. If it is found to have such an interest, it is not subject to the "bailout" dangers that section 306 seeks to prevent. Therefore, it will not be subject to the ordinary income rates upon sale that section 306 stock would be.

The facts in Revenue Ruling 81-91 involve a corporation having a total of ten shareholders each owning twenty shares of stock. The corporation was recapitalized, for legitimate business reasons, under a tax-free plan in which each outstanding share was exchanged for one share of each Class A and Class B stock. The classes of stock were defined as follows:

Each share of Class A and Class B stock had a par value of 10x dollars. The Class B shares were entitled to an annual cumulative dividend of 6 per cent of par value payable before any dividend was payable on Class A shares, and a prior right to repayment up to par value in the event of liquidation. After the satisfaction of the Class B stock's preferences, each share of Class A and Class B stock shared equally
as to dividends and on liquidation. Each class of shares carried equal voting rights and neither class was by its terms redeemable. 888

The preferred stock (class B) had a right to participate in corporate decisions as well as a right to receive assets upon liquidation equally with the class A stock. The court stated that “sale of the class B stock cannot occur without a loss of voting control and interest in the unrestricted growth in the corporation. Therefore, the bailout abuse that Congress sought to prevent by enactment of section 306 cannot be effected through a sale of the class B stock.” 889

By this process of favoring substance over form, the IRS found that the class B stock was not section 306 stock but, in fact, “common stock.”

B-10.09 Loans - Strawman Corporation

In Schlosberg v. United States, 840 a limited partnership was formed for the purpose of constructing and operating an apartment building in Washington, D.C. At that time, the District’s usury laws, which applied both to individuals and partnerships, permitted lending institutions to charge corporations a higher rate of interest than that charged partnerships and individuals. The National Bank of Washington (NBW) required that a corporation execute the loan documents. This enabled NBW to charge the higher interest rate. The partnership’s general partners and one other person formed a corporation specifically for this purpose. This new body received title to the property, executed the loan agreement, and subsequently reconveyed the property back to the partnership.

Following completion of the building by the partnership, the straw corporation was resurrected in order to obtain permanent financing. At this point, the property was conveyed to the corporation and one loan agreement was signed, followed by the reconveyance of the property to the partnership.

The IRS contended that this series of transactions was a sham engaged in by the partnership to preserve its ability to pass deductions to its members. The partnership admitted it had originally chosen this organizational form because of its tax advantages. The court agreed that this was a proper purpose. In this case, because the corporation generated no income, the contested deductions were of no value to it.

In upholding the right of the partnership to the claimed deductions, the court looked to the substance rather than the form of the transaction. “The momentary ownership by the corporation for reasons unrelated to tax purposes does not mean that the property must be forever deemed tied

888 Id.
889 Id.
to the corporate form for tax purposes even after it has been reconveyed to the partnership.\footnote{341}

The court further stated that the time in which the property was held by the corporation was too brief to attribute any payments to it.\footnote{342} The interest on the loans and other expenses were actually paid by the partnership and, therefore, were deductible by each member participating in it.

B-10.10 Triangular Merger - Loss Carrybacks

In *Bercy Industries Inc. v. Commissioner*,\footnote{343} the surviving corporation of a triangular merger\footnote{344} suffered losses which it carried back to offset the net income of the transferor corporation in its two preceding tax years. The Commissioner disallowed this carryback and was upheld by the Tax Court.\footnote{345} The Ninth District Court of Appeals, agreeing with a prior decision in the Second Circuit, reversed.\footnote{346}

The dispute concerned section 381(b)(3) of the Code which limits post-reorganization loss carry-backs by the surviving corporation of certain tax-free reorganizations. The government took the position that the legislative intent with regard to section 381 was to prevent carrybacks of post-reorganization losses when the legal and economic identity of the corporation has been substantially altered.

The court, however, agreed with the plaintiff's contention that it was not the intent of Congress to restrict carrybacks in a reorganization which "generates no complex problems of post-reorganization loss allocation"\footnote{347} even though triangular mergers were not specifically covered by the statute. Rather, the court determined that the intent was merely to prevent unmanageable administrative problems associated with allocating losses among entities in these types of mergers. An examination of Senate hearings with respect to the enactment of Section 381(b)(3) convinced the court that absent complex allocation problems, there should be no limit on carrybacks.\footnote{348}

Without determining precisely under which category of reorganization the triangular merger would qualify the court decided the case in favor of the corporation and granted the carryback based on a lack of administrative problems in this factual setting. As the court stated "the indisputable fact
is that the same business generated both the income and the loss.\textsuperscript{349} However, absent such compelling facts a contrary decision could be possible.

\textbf{B-10.11 Tax Benefit Rule - Liquidations}

A recent letter ruling reflects the position of the IRS as to the time to apply the tax benefit rule to corporate liquidations.\textsuperscript{350} According to this ruling, the rule should be applied when there is such an interrelationship between the event which constitutes the loss or deduction and the event which constitutes the recovery that they can be considered as parts of the same transaction. The IRS also contends that the benefit rule overrides the non-recognition provisions of section 336.\textsuperscript{351}

However, recent decisions of the Tax Court and the Ninth Circuit are in conflict over this question. The Tax Court, in \textit{Bonaire v. Commissioner},\textsuperscript{352} applied the tax benefit rule to a corporation which had paid twelve months of management fees in advance and then liquidated five months later. The corporation used the cash basis method of accounting and, therefore, had deducted the full twelve-month payment from its income. The Tax Court first held that the advance payment for services for the remaining seven months was not an ordinary and necessary expense because prepayment was not required. The court then alternatively held that the tax benefit rule would require inclusion of the seven months' fees in the corporation's income. The court said the recovery was met because the expensed fees for the additional seven months had a fair market value in the liquidation distributions. This decision followed the position of the Sixth circuit.\textsuperscript{353}

The Ninth Circuit Court of Appeals, in \textit{Bliss Dairy v. United States},\textsuperscript{354} however, declined to apply the tax benefit rule. That case involved a corporation, a cash basis taxpayer, which paid for and deducted the cost of cattle feed. At the beginning of its next fiscal year, the corporation was liquidated but some of the cattle feed still remained. The district court denied application of the tax benefit rule relying on the court of appeals decision in \textit{Commissioner v. South Lake Farms}.\textsuperscript{355} The Ninth Circuit agreed that that case was controlling and said in both situations the liquidating corporation received no economic benefit from the transfer of its assets to its shareholders, and section 336 prevented the recognition of income to the corporation.

Thus, the issue of when the tax benefit rule applies in corporate liqui-

\textsuperscript{349} 640 F.2d at 1062.
\textsuperscript{350} Letter Ruling 8120139 (1981).
\textsuperscript{352} Id.
\textsuperscript{354} 645 F.2d 19 (9th Cir. 1981).
\textsuperscript{355} 324 F.2d 837 (9th Cir. 1963).
dations is subject to future debate. The IRS will probably seek other cases to attempt to enforce its position.

B-10.12 Debt/Equity Regulations

The final regulations for section 385 concerning the classification of debt or equity (stock) of corporate interests have been postponed due to negative reactions by the business community. The new effective date is December 31, 1981. Criticisms and comments may be sent to the IRS until this date.

B-11.00 Subchapter S Corporations

B-11.01 Subdivision of Property

Subdivision of real property does not by itself prove that the property was being held primarily for sale to customers, subjecting any gain on its sale to ordinary income tax treatment. Rather, various factors must be taken into consideration to determine whether the property has been held primarily for sale to customers. These factors include the nature and purpose of the acquisition of the property; the number and substantiality of the sales; the extent of subdividing, developing, and advertising to increase sales; and the use of a business office to increase sales.

In Buono v. Commissioner, taxpayers purchased 130 acres of real estate intending to hold the property for 1½ years and then resell it at a profit. Taxpayers then formed a Subchapter S corporation and contracted with engineers to draft a map showing the division of land into respective lots, street layouts, and the proposed location of water and sewer lines. A small portion of the real estate was condemned by the state to provide for a new road; another fifteen acres were sold separately as a shopping center lot; and the remaining acreage was sold to a single purchaser.

The Commissioner maintained that the taxpayers were in the business of “packaging a product” due to the subdivision activities, and therefore, the gain from the sale should be treated as ordinary income because the property was held primarily for sale to customers.

The Tax Court disagreed and held that several factors must be considered when determining whether or not the property was being held primarily for resale to customers. The crucial factor is the taxpayers’ intentions, and here the court found that taxpayers at all times intended to sell the unimproved property as a single tract. Therefore, the gain from the sale was a capital gain. The Commissioner has since acquiesced in the Tax Court’s decision in this case.

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359 Id. at 198.
360 Id. at 201.
B-11.02 Guaranteed Bank Loans

A net operating loss of a Subchapter S corporation may be taken as a pro rata deduction from gross income of each shareholder. This deduction is limited to the total of the shareholder’s adjusted basis in the stock of the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder. The Tax Court held in Williams v. Commissioner that when proceeds of a loan obtained by the corporation but guaranteed by the shareholder are used to cancel debts of the corporation to the shareholder, the shareholder’s adjusted basis in the indebtedness is reduced, thereby reducing his maximum allowable net operating loss deduction.

In Williams, the shareholder of a Subchapter S corporation guaranteed a bank loan to the corporation. The bank then used part of the loan proceeds to credit the shareholder’s prior bank loans. The Commissioner claimed that this repayment reduced the shareholder’s adjusted basis in the corporation. The shareholder contended that since the corporation did not receive these loan proceeds, his basis should not be reduced. The Tax Court agreed with the Commissioner, holding the corporation was a constructive recipient of the loan, and the basis of the shareholder was reduced by the amount of the payment. Therefore, shareholders should be aware that proceeds used to cancel Subchapter S corporate indebtedness need not be received directly from the corporation before their adjusted basis in the loans can be reduced.

B-12.00 Partnerships

B-12.01 Allocation of Partnership Losses

The problem before the Tax Court in Richardson v. Commissioner concerned the allocation of losses among the partners of a limited partnership. In the case, several new partners were admitted into partnerships on December 31, 1974. These new partners, by the terms of the partnership agreement, were given 99 percent interest in the profits and losses for that year, and a declining percentage in the following years. The partnerships used the funds acquired from the new partners to pay previously accrued expenses on December 31. The petitioners in Richardson sought to utilize an interim closing-of-the-books method. The IRS contended that the only reasonable methods of allocation were to permit a deduction for the percentage of the tax year the new partners were members of the partnership (1/365 in this case) or to allow the new partners a deduction only for those expenses actually incurred and paid on December 31, 1974. The Court noted that “any reasonable method of allocating profits and losses for the period to and after the sale or exchange of interests is acceptable.”

The Tax Court also recognized that the timing and deductibility of de-

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362 I.R.C. § 1374.
365 Id. at 283.
366 1981 T.C.M. (P-H) ¶ 81,054 at 158.
ductions should be determined by the accounting method used by the partnership. The court held that since the partnership had used the cash method of accounting and that the allocation of losses occurring on December 31, 1974, reflected economic reality and was reasonable, the petitioners could utilize the interim closing of the books method for the allocation of the losses of the partnerships.

B-12.02 Small Partnerships - Filing Requirements

Section 6031 of the Code provides that all partnerships are to file a tax return for each taxable year. The failure to complete such a return may result in the imposition of the penalty prescribed by section 6698 unless reasonable cause is shown for failure to file. Revenue Procedure 81-11, however, eliminates the need for partnership returns to be filed for certain small partnerships. This IRS determination was based on the Congressional intent evidenced by the Conference Committee Report concerning section 6698. The Report states that “[s]maller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of income, deductions, and credits of the partnership...” Even though this Conference Report seems to make the intent of Congress in this particular matter very clear, the instructions for the partnership return give no indication that smaller partnerships could be exempt from filing. Instead, the 1980 instructions speak to “every partnership” prior to giving notice of the possibility of penalties.

Revenue Procedure 81-11 sets out which partnerships are required to file. They include “partnerships with significant financial holdings, tier partnerships, and partnerships where each partner’s interests in the capital and profits are not owned in the same proportion or where all items of income, deductions, and credits are not allocated in proportion to such pro rata interests.” While providing an advantage to the small partnership which have not historically filed a partnership return, Revenue Procedure 81-11 requires care in determining the status of a partnership.

After determining that a partnership status is one that is exempt from filing, attention must then be given to whether each partner includes his share of the income, deductions and credits on his individual return. This Revenue Procedure cautions that although each case is viewed upon consideration of all the facts and circumstances, a partnership may be found to have not fully reported if an “error or omission results in a material understatement of the net amount payable with respect to any income tax.”

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366 Id. at 284.  
367 Id.  
371 Id. at § 3.04.
B-12.03 Prepaid Oil/Gas Drilling Expenses

In Stradlings Building Materials v. Commissioner, the Tax Court held that a deduction for prepaid intangible drilling expenses does not require full performance of the contract. In this case, the taxpayer corporation was a limited partner in an oil and gas development company. The taxpayer corporation made a capital contribution to the development company which then contracted for the drilling of six wells and paid in full the costs of the drilling. The taxpayer, which used the accrual method of accounting, then elected to deduct its share of the prepaid intangible drilling expenses at the end of its fiscal year. However, in the following year, the drilling contractor drilled only one of the wells and breached the contract concerning the remaining five wells by refusing to drill them. The IRS disallowed the taxpayer's deductions of prepaid expenses for those five wells, contending that current deductions for intangible drilling costs are available only for those costs which were actually incurred.

The Tax Court disagreed and stated that there are only four criteria to qualify for the deduction of intangible drilling costs: "(1) the taxpayer must hold an operating or working interest in the property being developed; (2) the costs in question must relate to the development of the property in which the taxpayer has a working or operating interest; (3) the nature of the expenditure must fall within the definitional guidelines provided by section 1.612-4(a), Income Tax Regs., and (4) the payment or incurrence of the costs must occur sufficiently early in the development stages so that the taxpayer is exposed to the unknown risks of development." The court noted that if the position of the IRS was adopted, then the petitioner, in effect, would have been required to foresee the drilling company's breach of the contract. The court viewed the situation from a June 30, 1973 perspective (which was the end of the petitioner's fiscal year) and held that since the breach of contract could not have been foreseen, there was "no logical basis on which to distinguish the deductibility of the prepaid costs associated with the one well subsequently drilled from the prepaid costs of the five wells subsequently not drilled."

C. Installment Sales Revision Act of 1980

On October 19, 1980 the Installment Sales Revision Act of 1980 was enacted, significantly changing the prior law regarding treatment of installment sales. The new Act defines an installment sale as a disposition of real property or a disposition of personal property by a nondealer for which at least one payment is to be deferred to a future tax year. The advantages

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375 Id.
376 Id. at 48.
378 Id. at § 2(a), 94 Stat. 2247.
of qualifying for installment treatment are the delay of recognition of some gain until future payments are received and spreading of the gain on the sale over more than one tax year. Although most of the basic concepts of the previous law are continued, the new Act makes the specific changes below. Generally, the Act is effective for transactions occurring after October 19, 1980, but some sections become effective on different dates.

C-1.00 Structural Changes

The new law simplifies the prior law by unifying the basic rules for different types of transactions - under separate code sections. The basic rules relating to nondealer transactions are contained in section 453 of the Code. The basic rules relating to dealer transactions are now contained a new section 453A, while the generally applicable installment disposition rules are now contained in section 453B.

C-2.00 Initial Payment Limitation

Under prior law, payments received in the year of sale could not exceed 30% of the selling price, otherwise installment sales treatment was not available. The effect of the limitation has been to interfere with and complicate normal business transactions. If the 30% limitation was accidentally exceeded even slightly, the entire gain would have to be recognized in the year of the sale. The Act eliminates the 30% limitation and requires only that one payment be deferred for sales of real property on non-dealer personal property. Therefore, down payments of any amount are allowable.

C-3.00 Two Payment Rule

Under prior law, the IRS required two or more payments of the purchase price in two or more tax years. Therefore, a single payment could not be considered to be payable in installments. This interpretation led to the inequitable result of a seller receiving a single installment payment, having to pay taxes on the sale in the year of the sale and not receiving the payment until a subsequent year. The Act eliminates the requirements of the two-payment, thus allowing the seller to defer recognition of his gain until receipt of the payment.  

C-4.00 Selling Price Limitation for Casual Sales of Personal Property

Under prior law, a casual sale of personal property did not qualify for installment reporting unless the selling price was in excess of $1,000. This requirement raised issues as to whether a single sale of several items for more than $1,000 or a number of sales for under $1,000 qualified for installment treatment. The Act eliminates this limitation on casual sales of personal property. Thus there is no minimum selling price.

880 Id.
C-5.00 Election Out of Installment Reporting

Under prior law, installment reporting was available only to taxpayers who affirmatively elected to treat the transaction as an installment sale. In addition, inclusion of the entire gain in gross income was treated as a binding election not to report on the installment method. Amended returns were not allowed for taxpayers who forgot the election. The Act automatically applies installment reporting to a qualified sale, that is a sale falling within the statutory definitions, unless the taxpayer elects not to treat the transaction as an installment sale.\footnote{Id., at 4697-98.} It should be noted that a taxpayer may not want installment treatment if he has current losses to offset the gain or if he expects his future income to increase dramatically, making the gain subject to a higher tax bracket.

C-6.00 Related Party Sales

Under prior law, sales between related parties were permitted. Taxpayers could defer income through intra-family transfers of appreciated property. For example, the farmer/owner would sell some of his land to his son at the fair market value. The farmer would only recognize gain as the son made payments. The son could immediately sell the land to an unrelated third party. Because the son's basis in the property is its fair market value, the son would recognize little or no gain and the farmer could continue to defer his recognition of the gain, because of the son's installment payments. A similar device could be used with regard to the sale of appreciated market securities.

The Act requires that when the related purchaser (the son, in the above example) sells the appreciated property to the unrelated third-party for cash on its equivalent the original seller (the farmer) must recognize as an installment payment the amount from the sale to the extent at this amount exceeds the previous installment payments. A related person for purposes of this rule is one encompassed by section 318(a), generally spouses, and family members, certain trusts and 80% owned corporations or partnerships:

There are several exceptions to the new law. The original seller will not have to recognize his gain immediately if:

1. The second sale is after the death of either the original seller or the original buyer, or
2. the property is involuntarily converted, or
3. the second sale takes place more than two years after the date of the original sale, unless the property is marketable securities or has a substantial diminishing risk of ownership, or
4. the sale was of treasury stock, or
5. neither the original nor the second sale had as one of its principal purposes the avoidance of Federal income tax.\textsuperscript{382}

This new rule is effective retroactively to sales made after May 14, 1980, and will undoubtedly create havoc for related parties who did not know of the pending legislation.

C-7.00 Installment Obligations Distributed in a 12-Month Corporate Liquidation

Under prior law, if a corporation had elected a 12 month plan of complete liquidation, under section 337 and distributed installment obligations to the shareholders, the shareholders must recognize gain to the extent of the entire obligation. This, in effect, makes the shareholder liable for taxes before he receives the installment payments.

Under the new law, the shareholder may report the gain from the installment obligations received in the liquidation as installments.\textsuperscript{383} Hence, the shareholder is taxed only for payments actually received. However, installment obligations received from the sale of inventory, other than by bulk sale, do not qualify for installment treatment by the shareholder.

C-8.00 Cancellation of the Obligation

One strategy used under prior law was to cancel an obligation in the form of a gift, which was not, by some case law, considered to be a disposition. In this manner, the purchaser would obtain a cost basis in the property, and the seller would not have to recognize any gain. However, the new law states that such gifts will be treated as dispositions, and, therefore, the seller will have to recognize his gain immediately, using the fair market value of the obligation cancelled to calculate his gain.\textsuperscript{384} However, if the purchaser and seller are related parties, then the amount of the obligation cancelled is to be used.

A similar strategy utilized was to bequeath the obligation to the obligor. The new law neutralizes this strategy by requiring the seller's estate to recognize any unreported gain from an installment sale if the obligation is transferred to the obligor by bequest, devise, or inheritance. Similar treatment is accorded to cancellations by the executor. Since this law is not limited to specific bequests, care should be taken in drafting a will in which the obligor is a residuary beneficiary. A tax to the estate will result if the obligation is included in the residuary clause.

C-9.00 Sales Subject to a Contingency

A contingent sale is where the selling price is not fixed and determinable. Under prior law, if the selling price was contingent the taxpayer was required to recognize all gain in the year of sale, even though the installment payments had not yet been received.

The Act permits installment sales treatment for sales involving a contingent selling price. The Act prescribes that specific rules regarding qualifying transactions will be provided under treasury regulations.

According to temporary regulations recently released, if a sale has a maximum selling price, then this price must be used and all contingencies must be assumed to be construed in favor of the seller when calculating the gross profit ratio. If there is a fixed payout period, then the basis of the seller is to be ratably charged over this period against any payments received. If payments received during a year do not at least equal that portion of the basis charged for the year, then no loss can be taken for the year, and the unused basis is carried forward to the following year. A loss cannot be recognized until the last year of the installment contract. When there is no maximum selling price and no fixed payout period, the seller's basis is to be spread over 15 years, with unrecovered basis from any one year spread over the remainder of those 15 years. The income forecast method may be used where the income from the contract is to be spread unevenly throughout the life of the contract. When this method is used, the seller uses a forecast of total payments to calculate his gross profit ratio. Thus the cost recovery method treatment of a contingent sale, where the basis is fully recovered before the recognition of profit, will be more difficult to use under the new regulations. It can only be used in rare and extraordinary circumstances, such as a situation where the fair market value of the payments cannot be determined. If the seller attempts to use this method and it is disallowed, his attempt may be deemed an election not to use the installment method and he will have to recognize all of the gain immediately.

D. Bankruptcy Tax Act of 1980

The Bankruptcy Tax Act of 1980 amends the Internal Revenue Code by making several major changes in the tax treatment of bankrupt as well as solvent taxpayers. The 1980 Act establishes rules for the tax treatment of a debt discharge both within and outside of a bankruptcy proceeding. Other noteworthy highlights of the new Act are the creation of a separate taxable entity for income tax purposes arising from individual bankruptcies, the treatment of creditor reorganizations, and new procedural

rules coordinating tax law with the Bankruptcy Reform Act of 1978. Because there are various effective dates for different sections of the Act, the taxpayer must pay careful attention to these dates in order to ascertain the impact of the 1980 Act. In general the Act applies to transactions occurring after December 31, 1980.

D-1.00 Discharge of Indebtedness

Under prior law, a solvent debtor outside bankruptcy could elect to reduce the basis of either depreciable or nondepreciable assets to avoid inclusion of the discharged debt in gross income. The new rules under the 1980 Act provide that the election is limited to depreciable assets. This election applies to individuals or corporations with depreciable property, whose basis has been reduced, and is subject to the recapture provisions of the Code. An exception arises in the case of purchase money debts. If the seller reduces the debt of a solvent buyer, which arose out of a purchase money transaction, then the purchaser need not recognize any debt discharge income. This rule does not apply when the seller transfers the debt to a third party, nor does it apply to reductions for reasons other than direct agreements between buyer and seller.

D-2.00 Debtors in Bankruptcy and Insolvent Debtors Outside Bankruptcy

Prior to the 1980 Act, when a taxpayer was insolvent both before and after the debt discharge he realized no income. If the taxpayer was solvent after the discharge he realized income to the extent of his solvency, but he could elect to exclude this amount from gross income by reducing the basis in his assets.

Under the 1980 Act, insolvent debtors outside bankruptcy and debtors in bankruptcy do not realize income from the discharge of indebtedness but must reduce tax attributes unless the debtor elects to reduce his basis in depreciable property. Tax attributes must be reduced in the following order: (1) a dollar for dollar reduction of net operating losses and carryovers; (2) a fifty percent reduction of the new jobs credit, the WIN credit, of carryovers in the investment tax credit (excepting the TRASOP credit), and the credit for alcohol used as fuel; (3) a dollar for dollar reduction of capital losses and carryovers; (4) if any debt discharge amount remains, then the debtor’s basis in assets will be reduced (however, the debtor’s basis in assets will not be reduced below the amount of his remaining undischarged liabilities); (5) a fifty percent reduction of foreign tax credit carryovers. Gains realized upon disposition of the reduced basis assets are subject to recapture.

D-3.00 General Rules Applicable to Solvent, Insolvent, and Bankrupt Debtors

Under prior law, a party related to a debtor could acquire his debt at a discount and the debtor would not realize any debt discharge income. Under the 1980 Act, the IRS may treat the acquisition of a debt by a person related to the debtor from an unrelated party as an acquisition by the debtor in order to determine the debtor's income. Debt discharge income results when the debt is acquired at a discount.

A related party, for purposes of this rule, is:

(1) a member of a controlled group of corporations (as defined for purposes of Code section 414(b)) of which group the debtor is a member; (2) a trade or business treated as under common control with respect to the debtor (within the meaning of Code sections 414(b) or 414(c)); (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of Code section 707(b)(1)); or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in Code section 267(b).

If a corporation issues its own stock to cancel a debt, no income arises from the discharge of indebtedness and no tax attribute reduction is required. This is so even if the value of the stock is less than the amount of the debt, unless the stock issued was a nominal amount.

Under prior law, the discharge of a partnership debt was treated as income to the partnership. Under the 1980 Act, the rules of exclusion from gross income and reduction of tax attributes will be applied at the partner level. Therefore, discharge of partnership indebtedness will not be treated as income to the partnership, but to the partners.

Other significant changes applicable to any debtor include the following: (1) For corporations, the income exclusion rule does not apply to acquisitions by the corporation of its own indebtedness from its stockholders; this was treated as contributions to capital under prior law. (2) The cancellation liability which would be deductible when paid is not treated as income when forgiven. (3) As a clarification to the tax benefit rule, the 1980 Act provides that if a deduction in a prior year increased a carryover that has not expired, then that deduction is deemed to have produced a tax benefit to the taxpayer. Therefore, under the tax benefit rule, the discharge of a prior obligation would be debt discharge income.

D-4.00 Individual Bankruptcy Estate

Under prior law, there was no determination in the Code as to whether

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391 Id.

an individual and his bankruptcy estate were separate entities. The IRS
maintained that they were separate entities, but some courts held otherwise.

The new law specifically states that an individual debtor's estate will
be treated as a separate taxable entity in Chapter 7 (relating to liquidations)
and Chapter 11 (relating to reorganizations) bankruptcies. However, no
separate entity results when an individual debtor commences a Chapter 13
bankruptcy (relating to adjustment of debts of an individual with regular
income.) Furthermore, corporations and partnerships in bankruptcy are
not treated as separate entities.

D-5.00 Rules for Corporations

The Bankruptcy Tax Act of 1980 creates a new type of tax-free re-
organization entitled a "G" reorganization. A "G" reorganization is a trans-
fer by a corporation of all or part of its assets to another corporation pur-
suant to a court approved plan of reorganization. The acquiring corpo-
ration's stock or securities must be distributed in a transaction that qualifies
under section 354, 355, or 356. The test is whether substantially all of the
assets are transferred to the acquiring corporation. In addition, the judicially
imposed "continuity of interest" requirement must be met in order for a
"G" reorganization to qualify for tax free treatment.

The new "G" reorganization provision does not require compliance
with state merger laws (as in type "A" reorganizations), does not require
that the target corporation receive solely stock from the acquiring corpo-
ration in exchange for its assets (as in type "C"), and does not require that
the former stockholders of the target corporation control the corporation.
The Act also extends "G" reorganization provisions to triangular reorganiza-
tions and reverse mergers.

The new Act permits corporations in bankruptcy or insolvency pro-
ceedings to liquidate and transfer assets directly to creditors or sharehold-
ers. This liquidation must be completed before the termination of the case,
rather than the regular twelve month period under section 337 of the Code.

The nonrecognition rule of section 351 does not apply where an un-
secured debt or a claim for accrued but unpaid interest is transferred for
stock or securities to a controlled corporation.

The new Act also provides that an individual's bankruptcy estate may
be a shareholder in a Subchapter S corporation without causing termination
of the Subchapter S election.
In the area of earnings and profits, the new law provides that the discharge of indebtedness of a corporate debtor increases the earnings and profits of the debtor corporation to the extent of the reduction of tax attributes.\textsuperscript{8} However, reductions in the basis of depreciable property will not increase earnings and profits immediately, but will be reflected in lower depreciation expenses taken over the life of the assets.

Finally, under the 1980 Act a corporation in bankruptcy will not be deemed to be a personal holding company if the avoidance of the personal holding company tax was not a major purpose for commencing or continuing the bankruptcy proceeding.\textsuperscript{9}

D-6.00 Jurisdiction and Procedure in Bankruptcy

The 1980 Act clarified some of the jurisdictional and procedural conflicts between the U.S. Tax Court and the bankruptcy courts. Generally, the bankruptcy court is given the authority to determine whether the issue of the debtor's tax liability should be decided in the bankruptcy court or in the U.S. Tax Court. Other procedures clarified by the new Act include the automatic stay on collection or assessment of certain tax claims against the debtor, and the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court.\textsuperscript{10}

E. Miscellaneous Tax Laws of 1980

The nine separate tax bills summarized in this section are popularly referred to as the Miscellaneous Tax Act of 1980.

E-1.00 Entertainment Facility Expense

The general rule, under section 274(a), allows a deduction for entertainment facility expenses only if activities of the facility were directly related to the taxpayer's active trade or business, or the facility was used for business discussion. Under the new provision,\textsuperscript{11} expenses of the facility are deductible if the recipient of the entertainment must include the costs for his entertainment in his gross income. For example, if a salesman receives a bonus or prize from his employer of a week at the company's lodge which is includable in the salesman's gross income, then the costs of the facility for that week are deductible by the employer.

E-2.00 Withholding - Sick Pay

Employees may now\textsuperscript{12} elect to have tax withheld from payments of sick pay made to him by a third party who is not his employer (e.g. an

\textsuperscript{8} Id. at § 5(f) (amending I.R.C. § 312).

\textsuperscript{9} Id. at § 5(a) (amending I.R.C. § 542).


insurance company). Previously, no tax was required to be withheld by the employer which created the possibility of a penalty tax being imposed upon the employee.

E-3.00 Amortization - Business Startup Costs

Under section 195, start-up costs incurred before the commencement of business were nondeductible because they were not incurred in carrying on a trade or business. These costs were to be capitalized and not depreciated or amortized, but could be included in determining gain or loss upon sale or termination of the business. The new amendment to section 195 allows the business an election to capitalize start-up costs incurred after July 29, 1980, and to amortize them over a period of not less than sixty months.

E-4.00 Professional Corporation - Pension

A professional corporation had been able to avoid providing benefits to certain employees by the formation of a partnership with another professional corporation, each being a fifty percent partner. Unless an employer retained at least a 51% interest in the business, the Code did not require him to provide pension benefits. By the 1980 amendments, for purposes of the minimum participation standards, the test for control has been reduced to a ten percent interest.

E-5.00 Foreign Convention Expenses

Section 274, concerning deductions for expenses incurred in attending foreign conventions has been liberalized. The requirements under the new law are in some instances more strict than those under prior law, but once qualified, the taxpayer may have larger deductions available to him.

The maximum deduction allowed is subject only to the normal business expense deduction rules. The number of conventions qualifying as a deduction is no longer limited to two. Transportation expenses are no longer limited to the coach or economy fare rate and there is no limit on time spent for business purposes. Subsistence expenses are no longer limited to the per diem rate for civil servants. The only limitation is that expenses are not extravagant or lavish. In addition, reporting requirements are liberalized to be the same as domestic business travel expenses.

Previously, a taxpayer had to show that the primary purpose for attending the convention was business. The new law substitutes a "reasonableness" test based on:

1. the purpose and activities taking place at the meeting,
2. the purpose and activities of the sponsoring organization or group,

404 Id. at § 201, 94 Stat. 3526 (amending I.R.C. § 414(m)).
405 Pub. L. No. 96-608, § 4, 94 Stat. 3552 (amending I.R.C. § 274(h)).
(3) the residences of the active members of the organization and where other similar meetings have been held,

(4) other relevant factors presented by the taxpayer.\textsuperscript{406}

A convention will not be considered "foreign" under the new amendment unless it is held outside the "United States, its possessions, and the Trust territory of the Pacific Islands, and Canada and Mexico."\textsuperscript{407} However, no deductions will be allowed for conventions which occur on a cruise ship.

Taxpayers are still, however, subject to the allocation rules for foreign business travel. Taxpayers must be outside of the country for more than one week and must allocate expenses for the purpose of the deduction if less than 75% of the taxpayer's time is spent in business related activities.

E-6.00 Supplemental Unemployment Compensation - Repayments

If a laid-off taxpayer had collected supplemental unemployment compensation benefits (SUB) and then subsequently received trade readjustment assistance, in many instances he was required to repay the SUB benefits. The taxpayer had to repay at least $3,000 to qualify for tax relief under the claim of right doctrine as set forth in section 1341. If the repayment was less than $3,000, the taxpayer received no tax relief unless deductions were itemized. Amended\textsuperscript{408} section 62(16) now allows a deduction from gross income for repayments of SUB benefits required by receipt of subsequent trade readjustment assistance.

E-7.00 Oil/Gas Percentage Depletion - Allocation

Under section 55, the transfer of proven oil and gas properties after 1974 by an individual generally resulted in a disallowance of the percentage depletion. However, percentage depletion could be used if the transferee and transferor were required to allocate one depletable quantity. As amended,\textsuperscript{409} section 55 allows an individual to elect to transfer his property to a controlled corporation and to remain eligible for the percentage depletion deduction if the conditions of the section are met.

E-8.00 Pension Plans - Rollovers

Prior to the 1980 amendment\textsuperscript{410} to section 402(a), if an employee was covered by both a qualified money purchase pension plan and a qualified defined benefit plan, the employee could not roll over a distribution from the money purchase plan unless the defined benefit plan was also fully distributed.

\textsuperscript{406} Id.

\textsuperscript{407} Id. at § 3 (amending I.R.C. § 62).

\textsuperscript{408} Id. at § 3 (amending I.R.C. § 62).


\textsuperscript{410} Pub. L. No. 96-608, § 2, 94 Stat. 3551 (amending I.R.C. § 402(a)).
Under amended section 402(a), the employee may roll over the money purchase plan distribution into an individual retirement account or other qualified plan without a full distribution from the deferred benefit plan, and have the pension distribution be tax-free.

E-9.00 Alternate Minimum Tax - Tax Credit Offsets

Prior to the 1980 amendment, the foreign tax credit was the only credit that could offset the alternate minimum tax credit. Under amended section 55, a credit which is nonrefundable (i.e. if the credit is more than the tax liability) can be used to offset the alternate minimum tax which is attributable to the active conduct of a trade or business. Alternate minimum taxes attributable to capital gains or adjusted itemized deductions, however, may not be offset by the credit.

E-10.00 Pension - Debt Financed Real Estate

Income from debt-financed property owned by an employee trust for a qualified pension plan has been subject to income tax. The new law exempts income arising from real estate financed by debt from income tax to the qualified trust if the ERISA requirements are met.

E-11.00 Pension - Cafeteria Plan

A cafeteria plan provides that employees may choose among two or more benefits, which may be non-taxable benefits, or taxable benefits such as cash or property. Previously, a cafeteria plan could not provide for deferred compensation.

Under amended section 125, however, if a profit-sharing or stock bonus plan includes a qualified cash or deferred arrangement, the employee may elect to have the employer contribute such amounts as a non-taxable benefit.

F. Reasonable Compensation - Update

F-1.00 Overview

Section 162(a) of the Code deals with itemized deductions allowed in connection with a trade or business. Subsection (1) refers specifically to deductions allowed for "reasonable" compensation for services actually rendered by an employee to that trade or business. An entire series of cases have been decided by the courts in an attempt to determine exactly what compensation is reasonable. Decisions may be bound together by overlapping groups of factors that courts consider important in determining reasonable-

414 Id. § 226, 94 Stat. 3529 (amending I.R.C. § 125).
415 In Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949) the court explained:

Although every case of this kind must stand upon its own facts and circumstances, it is well settled that several basic factors should be considered by the Court in reaching its decision in any particular case. Such factors include the employee's qualifications;
ness, although there is no hierarchy as to which factors control. Each case is determined individually by viewing specific facts and circumstances surrounding the employer's business and economic status, as well as the importance of the employee's contribution to the trade or business.

Although the compensation set by a corporation's board of directors is ordinarily presumed to be reasonable, many problems arise when the corporation is closely held. Since, in this type of corporation, the employees are normally both members of the board of directors and shareholders, extreme care is taken by courts in ascertaining whether the amounts received by the employee are indeed compensation for services rendered and not dividends or a share of profits disguised as a salary or bonus. Prior to the passage of the Economic Recovery Tax Act of 1981 this determination had a dual impact. In addition to affecting the deductibility by the corporation of the payments made to the employee, the amount found to be actual compensation could also affect the individual's income tax rate. Under the old law, dividends paid to the employee could be subjected to a maximum marginal tax rate of up to seventy percent whereas the tax rate was limited to fifty percent for personal service income or compensation. Under the new law all income is limited to a fifty percent tax rate. The determination of reasonable compensation is still important, however, in determining the allowable deductions for a corporation. Even though the tax rate for the two types of income, personal service income and dividends, is now uniform, the courts are sure to distinguish between the two in order to determine the reasonableness of compensation received by an employee.

The cases discussed in this section deal with the treatment of the question of "reasonable compensation" by past courts and offer guidance for the future.

F-2.00 Home Interiors & Gifts, Inc. v. Commissioner

In Home Interiors and Gifts, Inc. v. Commissioner the Tax Court had to decide whether compensation consisting primarily of commissions and bonuses was reasonable. The major factors considered by the court in making its determination were the amount of compensation received by the employees as compared to similarly situated employees in comparable corporations, how the commissions received by these key employees com-

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415 Id. at 119.
pared to those received by other employees of the corporation, and how vital the services of these employees had been to the success of the corporation.\footnote{419}

The corporation in question was founded by Mrs. Crowley, who was also president and national sales manager.\footnote{420} She owned approximately 27% of the corporation in question. Her son, Mr. Carter, was executive vice president of the company and owned 19% of its stock.\footnote{421} The third employee whose compensation was being reviewed was Mr. Horner,\footnote{422} who became vice president for administration and owned less than one percent of the stock of Home Interiors.

The court looked to the particular circumstances surrounding the operation of the company and determined that the compensation received by these three employees was reasonable within the meaning of section 162(a)(1).\footnote{423} The court specifically noted the close working relationship Mrs. Crowley had with her force of managers and employees in both training them and encouraging their high volume of sales. This was important since the company sold home beautifying merchandise on a “hostess plan”\footnote{424} whereby the greater the amounts sold by the lower level employees, the greater the corporate earnings. In addition, Mrs. Crowley worked long hours and possessed what the court termed “rare talent” not easily replaceable.\footnote{425} Mr. Carter was also found to have made great contributions to the corporation through his many and varied services.\footnote{426} As to Mr. Horner, the court noted that since his compensation was determined in an arms length transaction it was unlikely that the company would pay him more than the value of his services.\footnote{427} As a factor supporting the taxpayers’ claims, the court also noted that the compensation of these three employees increased at a rate comparable to the compensation of other area managers of the company during the time period in question.

Since the compensation of the employees was prearranged and the company was still paying substantial dividends on its stock, the court determined that it was reasonable to continue to follow the compensation

\footnote{419 Id. at 639-41.}
\footnote{420 Id. at 630. See “Employee X” on Reasonable Compensation Table infra, F-9.00.}
\footnote{421 Id. at 633. See “Employee Y” on Reasonable Compensation Table infra, F-9.00.}
\footnote{422 Id. at 634. See “Employee Z” on Reasonable Compensation Table infra, F-9.00.}
\footnote{423 Id. at 634.}
\footnote{424 Under this plan products are sold by the sales representation to purchasers in the home of a cooperating hostess. The sales representative is an independent contractor who earns a profit when he sells at retail the products he bought from Home Interiors at wholesale. Id. at 630.}
\footnote{425 Id. at 639.}
\footnote{426 Id.}
\footnote{427 Id. at 639-40. Mr. Horner was not on the board of directors.}
contract.\textsuperscript{428} The court noted that this was true especially in light of the fact that although the compensation of these employees was increasing, the amount received was actually a lesser percentage of the company's earned profits.\textsuperscript{429}

Although the compensation of Mrs. Crowley, Mr. Carter, and Mr. Homer exceeded that of similarly situated employees in corporations of comparable size and economic status, the court held that the higher amounts were within the realm of reasonable compensation since these three individuals were so instrumental in the growth and success of the corporation.\textsuperscript{430}

F-3.00 Old Colony Insurance Service, Inc. v. Commissioner

The petitioner in \textit{Old Colony Insurance Service, Inc. v. Commissioner},\textsuperscript{431} was a Kentucky insurance company whose primary business involved selling mortality insurance on race horses. The two employees each received a salary of $64,223 as well as a commission at the end of the year.\textsuperscript{432} Each of the employees owned fifty percent of the corporation's stock and was, in addition, an officer and director of the corporation. The Commissioner asserted that the reasonable salary deductions to the corporation for each employee were actually $34,223. The Commissioner noted that the additional $30,000 claimed by the Corporation taxpayer was not deductible salary expense under section 162(a)(1) of the Code. Instead, the Commissioner contended that these disbursements were either a distribution of profits disguised as compensation or unreasonable compensation.

Several factors were urged as controlling by the IRS. First, because of the role of the employees in the corporation, there was no arms-length bargaining in the determination of compensation. Second, the corporation had failed to pay dividends. Third, there was a direct correlation between the ownership of stock by the employees and the amount of compensation each received. Finally, there was an increase in salary received by the employees at the end of the corporation's taxable year, which was a time when the year's profits could be determined with some certainty.

\textsuperscript{428} The court referred to Treas. Reg. \textsection 1.162-7(b)(2) (1960) citing the following portion as relevant:

\begin{quote}
Generally speaking, if contingent compensation is paid pursuant to a free bargain . . . before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.
\end{quote}

\textit{Id.} at 640.

\textsuperscript{429} \textit{Id.} at 641.

\textsuperscript{430} \textit{Id.}


\textsuperscript{432} \textit{Id.} at 569. One employee received a commission of $181,966, while the other received a commission of $23,220. The IRS did not contest the reasonableness of these amounts.
Although the Tax Court agreed that the failure to pay dividends is often an indication of possible compensation which actually represents a share of profit or dividends, it refused to give this factor overriding consideration. Strict scrutiny was used since the employees, in their roles as corporate directors, had determined their own salaries. Despite both of these factors, however, the Tax Court held in favor of the corporate taxpayer and refused to substitute its own judgment for that of the board of directors.

The court looked to the past employee payment history of the corporation and noted that for several years before the one in question, the employees involved had often been underpaid. It determined that any excess payment in 1974 was merely to make up for past services rendered. In addition, the court looked to the amount of work and time contributed by the employees to the corporate business. The court found that the services rendered by the two employees were indeed unique and necessary for the carrying on of the business in question. These two factors led the Tax Court to find that the deductions for compensation were properly claimed by the corporate taxpayer.

F-4.00 Schiff v. Commissioner

Another case which required the court to determine the reasonableness of compensation in a closely held corporation was that of Schiff v. Commissioner. This was necessary in order to set the maximum tax rate on the income in question and to ascertain its deductibility by the corporation.

The reasonableness of the compensation in this case was questioned since the two employees were the sole stockholders of the insurance corporation. Along with other employees of the corporation, the shareholders received a commission based on premiums for insurance policies sold. In addition, the taxpayers awarded themselves bonuses which were based on an estimate of the corporation's profits, as well as its projected cash needs rather than on a predetermined formula. One employee-shareholder received $80,199 in commissions and a bonus of $146,199 while the other received $86,852 in commissions and a bonus of $70,000.

While the IRS contended that the amounts paid to the taxpayers as compensation for personal service were excessive, the Tax Court disagreed and held that the total amounts constituted reasonable compensation within the meaning of section 162 and were therefore subject to the fifty percent maximum tax rate of section 1348, and were deductible by the corporation. The factors cited as favoring a finding of reasonableness were: (1) the two employees in question produced more business than the others; (2) they also produced less losses; (3) they were prompt in transmitting premiums.
to their chartered insurance company which increased the company's contingent commissions income; (4) the taxpayers supervised the training, sales and credit activities of the other employees; (5) the taxpayers negotiated with other insurance companies on behalf of their company; and (6) the amounts of commissions and bonuses were not proportionate to their shareholdings in the corporation.\(^{426}\)

Even though the entire amount in question was determined to be reasonable compensation, the court noted that the following facts might indicate the contrary: (1) the bonuses awarded were not determined by a formula or previous agreement; (2) estimates of profit and needed cash flow were made before the award of bonuses; (3) bonus payments were not subjected to withholding taxes; and (4) the amounts of corporation's dividends and retained income were small.\(^{437}\)

While the taxpayers prevailed in this instance, the court referred to their decision as "a close call."\(^{438}\) This seems to be a warning that the practice of awarding bonuses without some pre-arranged plan, and a practice of paying few dividends while returning only small amounts of capital in the corporation, will not be considered favorably in determining the reasonableness of compensation.

F-5.00 Foos v. Commissioner

In the case of \textit{Foos v. Commissioner},\(^{439}\) the court looked to the reasonableness of the compensation paid to two corporate employees\(^{440}\) to determine their taxable rate of income on their receipts from the corporation. Section 1348 of the Code makes the character of the income received by an individual important in determining the rate at which it will be taxed. Any reasonable compensation received in return for services rendered to the corporation would be earned income and therefore limited to a tax rate of fifty percent. On the other hand, if the income in question was determined to be unreasonable compensation for services, it would be a share of profits or dividends disguised as salary or a bonus and would not be limited to a fifty percent tax rate. The tax imposed on unearned income may be taxed at a rate of up to seventy percent.\(^{441}\)

The taxpayer, in an attempt to remain within section 1348, claimed that the corporation in question was a professional service corporation and

\(^{426}\) \textit{Id.} at 2461-62.

\(^{437}\) \textit{Id.} at 2462.

\(^{438}\) \textit{Id.}


\(^{440}\) Each of the employees had claimed compensation of $1,128,700 for 1974, $3,180,000 for 1975. In 1976, one employee claimed compensation of $1,484,000 while the other claimed $1,388,000. 1981 Tax Ct. Mem. (P-H) Dec. ¶ 81,061 at 186.

\(^{441}\) The Economic Recovery Tax Act of 1981 has lowered the maximum income tax rate to 50 percent. However, the issue remains viable because dividends are not deductible by the corporation, while salary expenses are deductible.
that all income received was a result of professional services rendered and, therefore, constituted earned income. The taxpayers were involved in a coal brokerage business. They bought coal from mines and sold it to users. The taxpayer advanced several reasons in support of the corporation's status as a professional service corporation\textsuperscript{442} which they contended should bring all resulting income within the parameters of section 1348. The court rejected such a classification noting that income from professional service corporations is derived solely from fees for professional services. In this instance, the funds generated by the business were not paid for the services themselves, nor were they commissions. The court found that they were simply profits on sales and found it necessary to turn to other factors to determine the reasonableness and nature of the compensation in question.

The court considered several factors\textsuperscript{443} in determining whether the compensation was reasonable. As a result, it determined that although it is proper for a corporation to pay its employees on a percentage basis where profits are largely a result of employee efforts, they are still subject to a reasonable and necessary standard under section 162(a)(1). In this case although the court agreed that ninety percent of the Company's profits paid as compensation was too much, the taxpayer had sustained the burden of showing that the Commissioner's estimates were too low. As a result, the presumption that the Commissioner's figures were correct was no longer in effect. In determining the reasonable amount of compensation, the Tax Court considered the facts of the case, placing great emphasis on the fact that the employees devoted extremely long hours to the company. The court noted that the company employed few employees, yet were able to generate a substantial volume of business.\textsuperscript{444} The court allowed the following amounts as reasonable compensation for the years in question. Each employee was allowed $807,930 in 1974 and $1,606,210 in 1975. In 1976, one employee was credited with $1,044,930 while the other was permitted $948,930.\textsuperscript{445}

F-6.00 Cromer v. Commissioner

The failure to pay dividends coupled with the payment of an extremely high percentage of corporate income as compensation served as a basis for a determination that reasonable compensation had not been paid in the case of Cromer \textit{v. Commissioner}.\textsuperscript{446} In making this determination the Court looked, again, to the facts and circumstances of the individual case.

Cromer was the president and sole shareholder of Capitol Air Service, Inc. In addition to his duties as president, he acted as a pilot, charter pilot, dispatcher and flight instructor. Shortly after becoming president of Capitol,

\textsuperscript{443} \textit{Id.}
\textsuperscript{444} \textit{Id.} at 198.
\textsuperscript{445} \textit{Id.} at 192.
\textsuperscript{446} 1980 Tax Ct. Mem. (P-H) Dec. ¶ 80,263 at 1155,
Cromer entered into an employment contract with Capitol. The contract established that Cromer would receive $103,800 annually as well as a bonus which was to be determined according to a specified formula. Although prearranged formulas are often an accepted means of assuring the reasonableness of compensation at a future date, the court gave little emphasis to the existence of such a formula, since there was an absence of arms-length bargaining. The court noted that the formula resulted in the payment to Cromer 99.7 to 99.9% of Capitol's income. This, coupled with the fact that no dividends were paid by the corporation, led the court to the conclusion that some of the funds claimed as compensation for services were, in fact, dividends.

F-7.00 Giles Industries, Inc. v. Commissioner

In *Giles Industries, Inc. v. United States*, the Court of Claims used the Consumer Price Index as an indicator of the reasonableness of compensation. In a previous case between the parties, reasonable compensation for the three officers of the corporation was determined by the court for the years 1964-1967. The issue before the court in *Giles II* was the determination of reasonable compensation in the years subsequent to 1967.

In the years following 1967, the amounts claimed as deductions for compensation were steadily increased. The court used the Consumer Price Index of the Bureau of Labor Statistics to adjust the 1967 compensation to reflect inflationary changes in the acceptable levels for the years in question. In addition, the salary of each employee was adjusted to reflect his increase or decrease of duties. In reaching its decision, the court also considered the average officer compensation paid by other industries.

F-8.00 Shotmeyer v. Commissioner

In *Shotmeyer v. Commissioner*, compensation paid to the chief executive officer and sole shareholder of Shotmeyer Petroleum was challenged on two bases. First, the IRS claimed that Mr. Shotmeyer spent the majority of his time at his Florida residence and was semi-retired and therefore was not entitled to as much compensation as he had received in the past. Second, the Commissioner challenged the legitimacy since a dividend had never been paid by Shotmeyer Petroleum. Despite these circumstances, the court determined that the compensation paid by the corporation to Mr. Shotmeyer was reasonable.

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447 Id. at 1159.
448 Id.
449 650 F.2d 274 (Ct. Cl. 1981).
450 Giles Indus. v. United States, 496 F.2d 556 (Ct. Cl. 1974).
451 650 F.2d at 278.
453 Id. at 1046.
In rejecting the IRS' first contention, the court noted that while Mr. Shotmeyer did, indeed, spend much of his time in Florida during the years in question, legitimate business reasons accounted for his continued presence there. First, Mr. Shotmeyer investigated "the potential for expansion of Shotmeyer Petroleum's business into the Florida market." as well as the possibility of acquiring several Florida businesses. In addition, Shotmeyer maintained daily contact with the New Jersey home office. When in New Jersey, Shotmeyer worked long hours and Saturdays at the home office. This served to refute any argument that Shotmeyer was easing his way into retirement. To the contrary, the court looked to his many contributions and dedication to the corporation as support for the reasonableness of the compensation he received. The court noted:

Taking the highest salary paid to either of the two sons and adding thereto the additional value to the corporation of Mr. Shotmeyer's experience, business acumen, contacts, securing corporate debts, high esteem among his peers in the industry, and his foregoing of either a pension or profit sharing plan and life insurance and his undercompensation in previous years, we find that Shotmeyer Petroleum properly characterized its payments to Mr. Shotmeyer as Compensation.

The court found that the failure of Shotmeyer Petroleum to pay dividends was not fatal to its claim that Mr. Shotmeyer received reasonable compensation. In considering the dividend issue the court states:

If its stock were owned by an unrelated third party who had advanced capital, there would naturally come a time when that party would become restless over Shotmeyer Petroleum's failure to pay a return on his investment. We are not prepared to say that it had reached that point with respect to its taxable years here in issue, although we certainly do not predict what our reaction would be to a similar failure to pay dividends in the future.

This leaves no doubt as to the continued importance of the payment of corporate dividends in the determination of reasonable compensation in a closely held corporation. However, it is not yet the prime consideration.

454 Id.
455 Id. at 1049.
456 Id.
### Reasonable Compensation Table

<table>
<thead>
<tr>
<th>BUSINESS OF TAXPAYER</th>
<th>STOCK OWNERSHIP OF EMPLOYEE</th>
<th>CLAIMED COMPENSATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home decorators and accessories sales</td>
<td>X owned 27%</td>
<td>Emp. X ranged from 566,364 in 1971 to 1,137,023 in 1975</td>
</tr>
<tr>
<td></td>
<td>Y owned 19%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Z owned less than 1%</td>
<td></td>
</tr>
<tr>
<td>§ 73.92 (1980)</td>
<td>'71 - 63,549</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'72 - 1,800,274</td>
<td>Emp. Y ranged from 456,841 in 1971 to 1,135,749 in 1975</td>
</tr>
<tr>
<td>Tax Years: 71-75</td>
<td>'73 - 313,274</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'74 - 470,495</td>
<td>Emp. Z ranged from 71,232 in 1971 to 277,954 in 1975</td>
</tr>
<tr>
<td></td>
<td>'75 - 544,895</td>
<td></td>
</tr>
<tr>
<td>Insurance Brokerage</td>
<td>Each of two employees owned 50%</td>
<td>Emp. A 64,223(s) 181,966 (com.)</td>
</tr>
<tr>
<td>Old Colony Insurance Service, Inc. 1980 T.C.M. (P-H) § 81,177</td>
<td>No dividends paid by employer</td>
<td>Emp. B 64,223(s) 23,220 (com.)</td>
</tr>
<tr>
<td>Tax Year: 74</td>
<td></td>
<td>(s) - salary (com.) commission</td>
</tr>
<tr>
<td>Insurance</td>
<td>Each of two employees owned 50%</td>
<td></td>
</tr>
<tr>
<td>John J. Schiff 1980 T.C.M. (P-H) § 80,578</td>
<td>Employer paid dividends:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'73 - 7,145</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'74 - 910</td>
<td></td>
</tr>
<tr>
<td>Tax Years: 73-74</td>
<td>'74 - 141,266</td>
<td></td>
</tr>
<tr>
<td>Coal Brokerage</td>
<td>Each of two employees owned 50%</td>
<td>Emp. A 1,128,700</td>
</tr>
<tr>
<td>Helen L. Foos 1981 T.C.M. (P-H) 81,061</td>
<td>Employer paid dividends:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'74 - 136,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'75 - 143,574</td>
<td></td>
</tr>
<tr>
<td>Tax Years: 74-76</td>
<td>'76 - 789,585</td>
<td></td>
</tr>
<tr>
<td>Commuter air carrier</td>
<td>Employee is sole shareholder</td>
<td>'73 - 329,300</td>
</tr>
<tr>
<td>Gary N. Cromer 1980 T.C.M. (P-H) § 80,263</td>
<td>Employer paid dividends:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>'70 - 91,000</td>
<td></td>
</tr>
<tr>
<td>Tax Years: 73-76</td>
<td>'76 - 396,800</td>
<td></td>
</tr>
<tr>
<td>Petroleum</td>
<td>Employee is sole shareholder</td>
<td>'73 - 137,225</td>
</tr>
<tr>
<td>Henry Shotmeyer 1980 T.C.M. (P-H) § 80,238</td>
<td>No dividends paid by employer</td>
<td>'74 - 176,900</td>
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<tr>
<td>Tax Years: 73-75</td>
<td>'75 - 136,900</td>
<td></td>
</tr>
<tr>
<td>Sale of agricultural and industrial equipment</td>
<td>Employee is sole shareholder</td>
<td>'75 - 181,074</td>
</tr>
<tr>
<td>Elliotts, Inc. (1980 T.C.M. (P-H) § 80,282</td>
<td>No dividends paid by employer</td>
<td>'76 - 193,663</td>
</tr>
<tr>
<td>Tax Years: 75-76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of nuts and bolts</td>
<td>A owned 49,998 of 50,000 shares</td>
<td>Emp. B 40,100</td>
</tr>
<tr>
<td>R. J. Kremer Co. 1980 T.C.M. (P-H) § 80,069</td>
<td>B &amp; C each owned 1 share</td>
<td>'74 - 55,230</td>
</tr>
<tr>
<td></td>
<td>No dividends paid by employer</td>
<td>'75 - 52,650</td>
</tr>
<tr>
<td>Tax Years: 73-75</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing of industrial furniture finishes</td>
<td>B had once owned 50%, he</td>
<td>Emp. A 72 - 70,000</td>
</tr>
<tr>
<td>Snyder Brothers Co. 1980 T.C.M. (P-H) § 80,275</td>
<td>transferred 25% to A and 25%</td>
<td>'73 - 88,000</td>
</tr>
<tr>
<td>Tax Years: 72-74</td>
<td>to third party</td>
<td>'74 - 91,500</td>
</tr>
<tr>
<td></td>
<td>Dividend amounts not clear</td>
<td></td>
</tr>
<tr>
<td></td>
<td>from case</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Emp. B 72 - 28,000</td>
<td></td>
</tr>
</tbody>
</table>
### Commissioner Allowed as Reasonable

<table>
<thead>
<tr>
<th>Employee</th>
<th>Years</th>
<th>Compensation</th>
<th>Adjusted for Cost of Living to July 1981 (Measured by Consumer Price Index)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emp. X</td>
<td>1971 to 1975</td>
<td>145,000</td>
<td>120,000 to 1,876,000</td>
</tr>
<tr>
<td>Emp. Y</td>
<td>1971 to 1975</td>
<td>92,000</td>
<td>1,032,000 to 1,874,000</td>
</tr>
<tr>
<td>Emp. Z</td>
<td>1971 to 1975</td>
<td>62,071</td>
<td>161,000 to 459,000</td>
</tr>
</tbody>
</table>

### Court Determines as Reasonable Compensation

<table>
<thead>
<tr>
<th>Employee</th>
<th>Years</th>
<th>Compensation</th>
<th>Adjusted for Cost of Living to July 1981 (Measured by Consumer Price Index)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emp. X</td>
<td>Court accepted figures of Taxpayer</td>
<td>1,280,000</td>
<td>1,876,000</td>
</tr>
<tr>
<td>Emp. Y</td>
<td>1,032,000 to 1,874,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emp. Z</td>
<td>161,000 to 459,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Adjusted for Cost of Living to July 1981

- **Emp. X**: Ranged from 145,000 in 1971 to 212,295 in 1975. Adjusted compensation was determined based on Taxpayer figures of 1,280,000 to 1,876,000.
- **Emp. Y**: Ranged from 92,000 in 1971 to 116,148 in 1975. Adjusted compensation was determined based on Taxpayer figures of 1,032,000 to 1,874,000.
- **Emp. Z**: Ranged from 62,071 in 1971 to 78,273 in 1975. Adjusted compensation was determined based on Taxpayer figures of 161,000 to 459,000.

### Additional Adjustments

- **Emp. A (34,223(s))**
  - Adjusted compensation was based on Court accepted figures of 113,700.
- **Emp. B (34,223(s))**
  - Adjusted compensation was based on Court accepted figures of 113,700.

### Emp. A

- **’73**: $97,885
- **’74**: $106,974
- **’75**: $95,857
- **’76**: $106,449

### Emp. B

- **’73**: $58,000
- **’74**: $14,050
- **’75**: $15,830
- **’76**: $18,250

### Emp. A

- **’73**: $301,000
- **’74**: $278,000
- **’75**: $268,000
- **’76**: $250,000

### Emp. B

- **’73**: $1,430,000
- **’74**: $2,650,000
- **’75**: $2,650,000
- **’76**: $1,490,000

### Court accepted figures of the Taxpayer

- **’73**: $122,500
- **’74**: $165,000
- **’75**: $153,000
- **’76**: $147,500

- **’73**: $252,000
- **’74**: $292,000
- **’75**: $252,000
- **’76**: $232,000

### 15,600 per year

- **’73**: $283,000
- **’74**: $313,000
- **’75**: $226,000

### Adjusted for Cost of Living

- **’73**: $107,000
- **’74**: $102,000

### Emp. B

- **’73**: $58,000
- **’74**: $49,000
- **’75**: $43,000

### Emp. A

- **’72**: $70,000
- **’73**: $88,000
- **’74**: $91,500
- **’75**: $153,000
- **’76**: $162,000

### Emp. B

- **’72**: $37,000