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# The Federal Circuit's 1985 Tax Cases: The Exercise of Equity

William S. Blatt
*University of Miami School of Law*, wblatt@law.miami.edu

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WILLIAM S. BLATT**

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INTRODUCTION

In its tax cases, the Court of Claims displayed two distinctive tendencies. The first was to ignore technical arguments and to decide cases on the basis of equitable considerations.[1] The second was to act independently: to make new law,[2] to disagree with circuit courts

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** Attorney, Morgan, Lewis & Bockius, Washington, D.C. A.B., (1978), Dartmouth College; J.D., (1982), Harvard Law School. I wish to thank Julie Gilbert, Susan Nash, Roger Pies, and Norman Schwartz for their comments on an earlier draft of this article. The views expressed in this article are mine alone.

1. *See* Brown, *Tax Refund Cases in the Court of Claims*, 32 ANN. N.Y.U. INST. ON FED. TAX'N 1305, 1307 (1974) (Court of Claims has "tendency to disregard technical tax rules and decides cases on the basis of what is fair"); Jones, *Choice of Forum in Tax Litigation Revisited*, 35 ANN. N.Y.U. INST. ON FED. TAX'N 373, 377 (1977) (Court of Claims is more willing than the Tax Court to take equitable arguments into consideration, even if large amounts are involved); Pavenstedt, *The United States Court of Claims as a Forum for Tax Cases*, 15 TAX L. REV. 201, 228 (1960) (recognizing Court of Claims' evident desire to disregard technical rules if taxpayer can show he has paid more taxes than government, in good conscience, should retain). *But see* Miller, *Tax Litigation in the Court of Claims*, 55 GEO. L.J. 454, 476-77 (1966) (few generalizations regarding Court of Claims' attitude in tax cases may be supported objectively).

2. *See* Brown, *supra* note 1, at 1307 (Court of Claims "has not hesitated to make new law in order to reach most equitable result"); Pavenstedt, *supra* note 1, at 228 (recognizing Court of Claims' willingness to make "new law" to prevent unjust enrichment).

and the Internal Revenue Service (Service), and to override existing administrative practice.[3]

The cases of a single year provide a thin sample from which to determine whether the Federal Circuit shares theses tendencies. In 1985, that circuit decided only thirteen tax cases and made substantive contributions in only six areas: partnership taxation,[4] income tax accounting,[5] international taxation,[6] taxation of tax-exempt entities,[7] taxation of cooperatives, and insurance company taxation.[8] Obviously, such a small selection cannot conclusively establish broad generalizations about the court's jurisprudence.

Nonetheless, the opinions issued during 1985 had a distinct flavor reminiscent of the Court of Claims. Foremost in these decisions was an attraction to equity. Frequently, the Federal Circuit adopted the rule that accorded with general tax principles or common sense.[9] In thus proceeding, it did not feel bound by technical language, but rather read words broadly[10] and gave them different meanings in different contexts.[11] The court also read the Internal Revenue Code *in pari materia*,[12] and added freely to statutory or regulatory language.[13] Related to the court's adoption of equitable principles was

3. *See* Jones, *supra* note 1, at 377 (Court of Claims may be less reluctant than Tax Court to override established administrative practices not clearly supported in law or regulation).

4. *See infra* notes 19-61 and accompanying text.

5. *See infra* notes 62-82 and accompanying text.

6. *See infra* notes 83-110 and accompanying text.

7. *See infra* notes 111-48 and accompanying text.

8. *See infra* notes 149-66 and accompanying text.

9. *See* Coplin v. United States, 761 F.2d 688, 691-92 (Fed. Cir. 1985) (holding that Panamanian government did not negotiate for relief of United States citizens from United States tax), *cert. granted sub nom.* O'Connor v. United States, 106 S. Ct. 784 (1986).

10. *See* Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (Fed. Cir. 1985) (reading all events test broadly), *aff'd*, 106 S. Ct. 2092 (1986); General Dynamics Corp. v. United States, 773 F.2d 1224, 1226 (Fed. Cir. 1985) (same), *cert. granted*, 106 S. Ct. 2913 (1986); Greenacre Found. v. United States, 762 F.2d 965, 966 (Fed. Cir. 1985) (reading "used" in statute to include potential use).

11. *See* Holiday Village Shopping Center v. United States, 773 F.2d 276, 279 (Fed. Cir. 1985) (treating partnership as aggregate or as entity depending on context); American Bar Endowment v. United States, 761 F.2d 1573, 1578 (Fed. Cir. 1985) (defining unrelated business taxable income differently for business leagues and charities), *rev'd* 106 S. Ct. 2426 (1986); Greenacre Found. v. United States, 762 F.2d 965, 967 (Fed. Cir. 1985) (acknowledging that "used" has different meanings in different parts of Code).

12. *See* Raphan v. United States, 759 F.2d 879 (Fed. Cir.) (reading principle of section 707 into section 752 regulations), *cert. denied*, 106 S. Ct. 129 (1985); Holiday Village Shopping Center v. United States, 773 F.2d 276, 280 (Fed. Cir. 1985) (extending principle of section 751 to nonrecognition transaction).

13. *See* Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir.) (adding condition that personal liability be in capacity as partner to regulation permitting limited partner to share in liability for which no partner has personal liability), *cert. denied*, 106 S. Ct. 129 (1985); Holiday Village Shopping Center v. United States, 773 F.2d 276, 280-81 (Fed. Cir. 1985) (adding partnership interest to list of depreciable property); American Bar Endowment v. United States, 761 F.2d 1573, 1578 (Fed. Cir. 1985) (adding to tax on unrelated business income an exemption for fundraising programs), *rev'd*, 106 S. Ct. 2426 (1986).

its heavy reliance on the doctrine of substance over form[14] and its willingness to reach results amenable to business needs.[15]

But the picture emerging from the Federal Circuit's 1985 tax opinions may not have coincided exactly with that of the Court of Claims. Although the Federal Circuit shared the Court of Claims' attraction to equity, it may have displayed less independence than its predecessor. The Federal Circuit was not swayed easily by revenue rulings or the opinions of other circuits,[16] but ultimately acquiesced to Treasury regulation and executive position.[17] This acquiescence may have been due to a deferential attitude or simply a favorable disposition toward the equitable arguments for administrative convenience present in those cases.[18]

## I. TAXATION OF PARTNERSHIPS

Perhaps the most distinctive Federal Circuit decisions involved partnership taxation. In two highly visible opinions, the Federal Circuit read the Code *in pari materia*. Drawing upon general principles contained in analogous sections, the court freely added to the

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14. *See* Holiday Village Shopping Center v. United States, 773 F.2d 276, 279 (Fed. Cir. 1985) (recapturing depreciation despite form of transaction as distribution of partnership interest); Massachusetts Mut. Life Ins. Co. v. United States, 761 F.2d 666, 669 (Fed. Cir. 1985) (finding character of insurance business unchanged by use of partnership form).

15. *See* General Dynamics Corp. v. United States, 773 F.2d 1224, 1226 (Fed. Cir. 1985) (finding all events test met for self-insured medical claims when medical services provided calculating deduction for such claims in the aggregate rather than individually), *cert. granted*, 106 S. Ct. 2913 (1986); Cotter and Co. v. United States, 765 F.2d 1102, 1106-07 (Fed. Cir. 1985) (permitting characterization of investment and rental income as patronage sourced when accumulation of such income is prompted by business needs); Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (Fed. Cir. 1985) (finding all events test met for progressive slot machines when jackpots registered thereon), *aff'd*, 106 S. Ct. 2092 (1986).

16. *See* General Dynamics Corp. v. United States, 773 F.2d 1224, 1226 (Fed. Cir. 1985) (reaching result contrary to revenue ruling), *cert. granted*, 106 S. Ct. 2913 (1986); American Bar Endowment v. United States, 761 F.2d 1573, 1578 (Fed. Cir. 1985) (distinguishing cases of three circuits), *rev'd*, 106 S. Ct. 2426 (1986); Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (Fed. Cir. 1985) (disagreeing with Ninth Circuit), *aff'd*, 106 S. Ct. 2092 (1986).

17. *See* Thomas Int'l Ltd. v. United States, 773 F.2d 300, 304-05 (Fed. Cir. 1985) (upholding regulation treating commissions receivable as qualified export assets only if paid within 60 days), *cert. denied*, 106 S. Ct. 1261 (1986); Greenacre Found. v. United States, 762 F.2d 965, 967-68 (Fed. Cir. 1985) (upholding regulation treating property that generally produces interest, dividends, rents, and royalties as in fact used for such production). *See also* Coplin v. United States, 761 F.2d 688, 691-92 (Fed. Cir. 1985) (deferring to executive interpretation of treaty), *cert. granted sub nom.* O'Connor v. United States, 106 S. Ct. 784 (1986); Massachusetts Mut. Life Ins. Co. v. United States, 761 F.2d 666, 669 (Fed. Cir. 1985) (relying on treasury regulation).

The Court of Claims was also perceived as a taxpayer court. *See* Jones, *supra* note 1, at 377; Pavenstedt, *supra* note 1, at 228. Regardless of the accuracy of this perception, it is difficult to discern any such tendency in the Federal Circuit in 1985. Nine of its thirteen decisions held for the government.

18. *See* Thomas Int'l Ltd. v. United States, 773 F.2d 300, 304-05 (Fed. Cir. 1985) (upholding easily administered regulation), *cert. denied*, 106 S. Ct. 1261 (1986); Greenacre Found. v. United States, 762 F.2d 965, 967-68 (Fed. Cir. 1985) (same).

literal language of the Code and regulations. Not unexpectedly, these cases sparked congressional reaction.

The first partnership opinion was *Raphan v. United States*.[19] The principal issue there was whether limited partners could include in the tax basis of their partnership interests, their share of nonrecourse[20] indebtedness guaranteed by the general partners.[21] The Code provides that a partner's basis in a partnership interest includes an amount equal to the partner's share of partnership liabilities, but is silent as to the effect of liabilities on a limited partner's basis in a partnership interest. The regulations allow a limited partner to include liabilities in basis in one situation: "[w]here none of the partners have any personal liability with respect to a partnership liability . . . then all partners, including limited partners, shall be considered as sharing such liability."[22] The question presented in *Raphan* was whether a guarantee by the general partner gave rise to personal liability with respect to a partnership liability within the meaning of the regulation so as to prevent the limited partners from sharing the liability.

Judge Kozinski of the Claims Court held that the limited partners could include their share of the debt in basis notwithstanding the general partner's guarantee of that debt.[23] Relying on the general principle of section 707(a)[24] that transactions undertaken by a partner in a capacity other than as a partner are to be considered as occurring between the partnership and one who is not a partner,[25] Judge Kozinski read into the regulation the requirement that a personal liability be assumed in the general partner's "capacity as partner" in order to preclude the limited partners from sharing in the liability.[26] Judge Kozinski apparently adopted a per se rule that the

19. 759 F.2d 879 (Fed. Cir.), *cert. denied*, 106 S. Ct. 129 (1985).

20. A "nonrecourse" liability is one for which no one is personally liable. WILLIS, PENNELL & PASTLEWAITE, PARTNERSHIP TAXATION, § 43.04 (3d ed. 1986). Conversely, a "recourse" liability is one for which someone is personally liable. *Id.* at § 43.01.

21. Raphan v. United States, 759 F.2d 879, 884-86 (Fed. Cir.), *cert. denied*, 106 S. Ct. 129 (1985).

22. Treas. Reg. § 1.752-1(e) (1960).

23. Raphan v. United States, 3 Cl. Ct. 457, 461 (1984), *aff'd*, 759 F.2d 879 (Fed. Cir.), *cert. denied*, 106 S. Ct. 129 (1985).

24. Unless stated otherwise, section references are to the Internal Revenue Code of 1954 as amended.

25. I.R.C. § 707(a) (1984) ("If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner").

26. *See* Raphan v. United States, 3 Cl. Ct. 457, 465 (1984) ("that test is whether, in assuming [the] liability, the general partner is securing rights and assuming responsibilities which are separate from, and independent of, his role as partner"), *aff'd*, 759 F.2d 879 (Fed. Cir.), *cert. denied*, 106 S. Ct. 129 (1985).

guarantee of a partnership debt is not an act taken in a partner capacity. He reasoned that if the partnership defaulted on the loan, the guarantor would have to pay the entire debt and would become "effectively a creditor vis-á-vis the partnership, with rights antithetical to his status as a partner."[27]

The Federal Circuit reversed Judge Kozinski's decision.[28] Like Judge Kozinski, the court was willing to read into the regulation the requirement that the assumption of personal liability be made in the partner's capacity as such.[29] The court disagreed, however, with Judge Kozinski's per se rule that guarantees are not made in a partner capacity,[30] and held that for a guarantee to be made in a nonpartner capacity, it must be made on arms length terms.[31] Applying this standard to the facts before it, the court found that the guarantee was not made on arms length terms because the general partners guaranteed the loan simply to profit through their partnership interests.[32]

The government did not view *Raphan* favorably. After issuance of the Claims Court opinion, the Service held in Revenue Ruling 83-151[33] that a nonrecourse loan guaranteed by a general partner did not increase the limited partners' bases in their partnership interests. It did so only after noting that "the guaranty by [the general partner makes him] personally liable to the extent that the value of the property securing the loan is insufficient to cover the amount due."[34] Later, in the Tax Reform Act of 1984,[35] Congress announced that "section 752 . . . shall be applied without regard to the result reached in the case *Raphan v. United States*."[36] The legislative history indicated that no inference was to be drawn regarding the validity of *Raphan* for transactions prior to March 19, 1984.[37]

Despite congressional action, the dust has not settled on the issue posed in *Raphan*. It is unclear how a general partner's guarantee of a nonrecourse loan affects limited partners' bases in their partnership interests. By overruling the Claims Court opinion in *Raphan*,

27. *Id.* at 466.
28. *See* 759 F.2d 879, 886 (Fed. Cir.), *cert. denied*, 106 S. Ct. 129 (1985).
29. *Id.* at 885.
30. *Id.*
31. *Id.*
32. *Id.*
33. 1983-2 C.B. 105.
34. *Id.* at 106.
35. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 79(a), 98 Stat. 494 (1984).
36. *Id. See Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, H.R. REP. No. 4170, 98th Cong., 2d Sess. 250-51, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 899 [hereinafter cited as *General Explanation*].
37. *General Explanation* at 251, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 899.

Congress intended to eliminate the per se rule that all guarantees are made in a capacity other than as a partner. The House Report contemplates issuance of regulations that will make capacity irrelevant and reflect the position taken in Revenue Ruling 83-151.[38] It is unclear, however, whether Congress intended that the regulations deny a basis adjustment for all loans guaranteed by a partner or only those loans of an amount less than the value of the property.

The second notable partnership taxation opinion was *Holiday Village Shopping Center v. United States*,[39] which considered whether a distribution of a ninety-nine percent interest in a partnership pursuant to a section 336 liquidation[40] triggered depreciation recapture on depreciable assets owned by the partnership.[41] Literally read, the Code did not provide for recapture. The recapture provisions override section 336, but apply only to dispositions of depreciable property.[42] Partnership interests themselves are not depreciable property and the transfer of a partnership interest does not effectuate a disposition of the underlying partnership assets. Recognizing this fact, Congress enacted section 751(a), which requires recapture of depreciation taken on partnership assets upon the sale or exchange of a partnership interest.[43] Section 751(a) does not, however, reach beyond sales and exchanges to nonrecognition transactions such as the section 336 liquidation at issue in *Holiday Village*.

By affirming the Claims Court decision, the Federal Circuit extended section 751 beyond its literal terms by holding that the transfer triggered recapture on partnership assets.[44] It began its analysis by noting that, depending on the context, the Code treats partnerships both as distinct entities and as a collection of individu-

38. H.R. REP. No. 432 Pt. 2, 98th Cong., 2d Sess. 1236 (1984).

39. 773 F.2d 276 (Fed. Cir. 1985).

40. *See* I.R.C. § 336(a) (1982) (providing generally that "no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation").

41. *See* Holiday Village Shopping Center v. United States, 773 F.2d 276, 277-78 (Fed. Cir. 1985). The recapture provision involved in the case was I.R.C. § 1250, which provides that: "[i]f section 1250 property is disposed of after December 31, 1975 . . . the excess of . . . the fair market value of such property . . . over the [taxpayer's] adjusted basis of such property, shall be treated as gain which is ordinary income"). I.R.C. § 1250 (1982).

42. *See* I.R.C. §§ 1245(a)(3) amended Pub. L. No. 99-121, 99 Stat. 509 § 105(b) (1985), 1250(c) (1984) (listing property subject to recapture).

43. I.R.C. § 751(a) (1982) ("The amount of any money . . . received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to . . . unrealized receivables of the partnership . . . shall be considered as an amount realized from the sale or exchange of property other than a capital asset").

44. Holiday Village Shopping Center v. United States, 773 F.2d 276, 282 (Fed. Cir. 1985).

als.[45] The Federal Circuit then defined the issue before it as whether the partnership should be treated as an entity or as an aggregate.[46] If the partnership was treated as an entity, the transfer of a partnership share would not result in recapture; if it was treated as an aggregate, the transfer would constitute a transfer of the underlying partnership assets and would trigger recapture.[47] Relying on the doctrine of substance over form,[48] the Federal Circuit held that the partnership should be treated as an aggregate.[49] It noted that reliance on the entity theory would create an anamolous result under which the recapture consequences would turn upon whether the assets received in liquidation were in partnership solution.[50]

Had it considered the issue, Congress probably would have concurred in the result of *Holiday Village*. In all likelihood, Congress did not intend to exempt property held in partnership solution from the general rule requiring recapture on depreciable assets distributed in section 336 liquidations. Otherwise, corporations could currently reduce ordinary income and indefinitely defer recapture by liquidating under section 336. And, the recipient shareholders might avoid the recapture tax altogether because their stepped-up basis in their partnership interests[51] might flow through to the partnership assets.[52]

In reaching its result in *Holiday Village*, however, the Federal Circuit caught on two snags. First, by framing its opinion around the general choice between the entity and aggregate theories of partnership taxation, the court raised the prospect that a single term, "partnership interest," might have different meanings in different contexts. Generally, unless explicitly stated otherwise, a partnership share is treated under the Code as an interest in a distinct entity.[53] By raising doubt as to this generalization, *Holiday Village*

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45. *Id.* at 279 (relying on H.R. REP. No. 2543, 83d Cong., 2d Sess. 59, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5280, 5319-20).

46. *Id.*

47. *Id.*

48. *See* Gregory v. Helvering, 293 U.S. 465, 470 (1935) (refusing to "exalt artifice above reality").

49. *See* Holiday Village Shopping Center v. United States, 773 F.2d 276, 280 (Fed. Cir. 1985).

50. *Id.*

51. *See* I.R.C. § 331 (1982) (treating amounts received by shareholder in complete liquidation as full payment in exchange for stock); I.R.C. § 334 (1982) (basis of property received in complete liquidation in which gain or loss is recognized is fair market value of such property at time of liquidation).

52. If a partnership makes a section 754 election, it steps up its basis in partnership assets on the transfer of a partnership interest. I.R.C. § 743(b) (1984). Such step up would reduce the amount of any subsequent recapture.

53. *See* Rev. Rul. 75-62, 1975-1 C.B. 188.

opens a can of worms.[54] For instance, the aggregate theory suggests that there should also be recognition on assets, such as LIFO inventory and installment receivables, for which there is normally recognition in a section 336 liquidation,[55] even if those assets are held in partnership solution. Yet, since a sale of a partnership interest does not trigger recognition on such assets, it is unlikely that Congress would have intended recognition on them when distributed pursuant to a section 336 liquidation. *Holiday Village* does not require recapture of such items, but by making the aggregate theory potentially applicable to them, the case injects an element of uncertainty into the law.

Second, the court equivocated as to the basis implications of its rule. A shareholder's basis in a partnership share distributed pursuant to a section 336 liquidation is the fair market value of the share.[56] Assuming that the distribution does not terminate the partnership and that no section 754 election is in effect,[57] no mechanism exists to increase the partnership's basis in the distributed assets. Without such a mechanism, the partner might be subject to a second tax attributable to the same appreciation when the partnership later disposes of the asset: a tax recoupable only upon ultimate disposition of the partnership interest. In discussing the basis implications of its decision, the court might have indicated satisfaction with the general tax rule that keeps the bases in partnership interests and assets distinct, or have extended its aggregate analysis to step up the partnership's basis in its assets. In fact it did neither. It said that the issue of basis was not before it and that the Department of Justice had made assurances that a basis adjustment was available.[58] The court's sidestep of this problem is incongruous with the overall tenor of its opinion. If, as its ultimate holding implies, the court was concerned with rationalizing the tax system, it should not have shut

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54. Holiday Village Shopping Center v. United States, 773 F.2d 276 (Fed. Cir. 1985), was not the first authority to do so. Prior to that case, the Service had adopted an aggregate analysis to require recognition of gain inherent in installment obligation receivables owned by a partnership upon transfer of an interest in such partnership. *See* Rev. Rul. 60-352, 1960-2 C.B. 208.

55. *See* I.R.C. § 336(b) (1982) (treating LIFO recapture as gain to the corporation upon distribution of LIFO inventory in liquidation); I.R.C. § 453(h) (1984) (recognizing gain inherent in installment receivables upon distribution in liquidation).

56. *See* I.R.C. § 334(a) (1982).

57. A partnership termination would pass up the partner's basis in his partnership interest to the partnership assets by triggering a constructive distribution and recontribution of the partnership assets. *See* I.R.C. §§ 723, 732(b) (1984); Treas. Reg. § 1.708-1(b)(1)(iv) (1984); McKEE, NELSON & WHITMORE, TAXATION OF PARTNERSHIPS ¶ 12.05[2][d] (1985). A section 754 election permits a partnership to adjust its basis in its assets upon the exchange of a partnership interest. *See* I.R.C. § 743(b) (1984).

58. Holiday Village Shopping Center v. United States, 773 F.2d 276, 281 (Fed. Cir. 1985).

its eyes so readily to the basis implications of its rule.[59]

The degree to which *Holiday Village* deviates from the literal language of the Code is suggested by the legislative response to that case. Satisfied with the result in *Holiday Village*, but apparently concerned that other courts would not reach it, Congress subsequently enacted Code section 386,[60] which treats a corporate distribution of a partnership interest as a distribution of the corporation's proportionate share of the partnership's recognition property for purposes of determining amount and character of gain.[61] Interestingly, Congress created no mechanism by which the partner's basis would pass through to partnership assets in the absence of a partnership termination or section 754 election.

## II. INCOME TAX ACCOUNTING

Another facet of the Federal Circuit's equitable orientation surfaced in its opinions regarding income tax accounting in which it demonstrated a willingness to read regulatory language expansively to comport with business realities. In reaching its conclusions, the court departed from positions held by other circuits and the Internal Revenue Service.

In *Hughes Properties, Inc. v. United States*,[62] the question presented was whether amounts registered on progressive slot machines[63] met the all events test[64] when local gaming commission regulations prohibited turning back the payoff indicators to lesser amounts.[65] Prior

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59. The decision also creates a recapture problem similar to that already existing under section 751(a)—that the recapture provision may recharacterize gain twice: once, on the receipt of the interest in liquidation, and again, on the subsequent sale or exchange of partnership property. *See* MCKEE, *supra* note 57, ¶ 16.03[3], at 16-29. "All or a portion of the recapture items that cause the seller of a partnership interest to be taxed at ordinary income tax rates may also generate ordinary income to the purchaser of the interest" if no section 754 election is in place. *Id.*

For criticism of *Holiday Village*, see MCKEE, supra note 57, ¶ 15.07[2], at S15-22.

60. Pub. L. No. 98-369, 98 Stat. 494, §§ 5761, 7701 (1984) (codified at I.R.C. § 386 (1984)).

61. *See* I.R.C. § 386(a) (1984) "For purposes of determining the amount (and character) of gain recognized by a corporation on any distribution of an interest in a partnership, the distribution shall be treated in the same manner as if it included a property distribution consisting of the corporation's proportionate share of the recognition property of such partnership." *See also General Explanation*, *supra* note 36, at 237.

62. *See* 760 F.2d 1292 (Fed. Cir. 1985), *aff'd*, 106 S. Ct. 2092 (1986).

63. A progressive slot machine is one with a guaranteed jackpot which is automatically increased, by a pre-set ratio, as the machine accumulates money.

64. *See* Treas. Reg. § 1.461-1(a)(2) (1984) ("[u]nder an accrual method of accounting, an expense is deductible for the taxable year in which all of the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy").

65. Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (Fed. Cir. 1985), *aff'd*, 106 S. Ct. 2092 (1986).

to *Hughes Properties*, the Ninth Circuit, in *Nightingale v. United States*,[66] had held that the test was not met: that the winning of the jackpot was the event that determined the fact of liability.[67] In *Hughes Properties*, the Federal Circuit declined to follow *Nightingale*.[68] It found that a fixed liability existed that was "not contingent upon the time of payment or the identity of the jackpot winner."[69] The court went on to state that the taxpayer's accounting method accurately reflected income: its method allocated the expenses incurred in producing revenue to the year in which the revenues were earned by matching the jackpot payable to the year in which funds to pay the jackpot were accumulated.[70]

The *Hughes Properties* result seems more the product of practical insight than of careful application of the all events test. The court did not discuss the possibility that the liability might never come into existence:[71] if the casino ceased operating before the registered amount was won, no liability to pay the jackpot amount would exist. If, however, the objective of income tax accounting is to reflect accurately income, the Federal Circuit decision is understandable. The decision shows an appreciation for the commercial realities of the gaming business.

A similar tendency was evident in *General Dynamics Corp. v. United States*,[72] in which the Federal Circuit considered two issues on which prior authority existed. The first was whether a self-insured employer met the all events test with respect to employees who had received medical care but whose claims had not yet been processed. On this issue, the Internal Revenue Service had already ruled that such expenses were not accrued until the medical insurance administrator had certified the employees' claims.[73] The second issue was whether the resulting deductions should be calculated in the aggregate or on an employee-by-employee basis. In *Eastman Kodak Co. v. United States*,[74] the Federal Circuit had previously required that the

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66. 684 F.2d 611 (9th Cir. 1982).

67. *Id.* at 614.

68. Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (Fed. Cir. 1985), *aff'd*, 106 S. Ct. 2092 (1986).

69. *Id.* at 1293.

70. *Id.*

71. For a decision attaching great weight to this factor, see World Airways v. Commissioner, 62 T.C. 786, 802-05 (1974) (no liability incurred under contract requiring engine and air frame overhauls upon completion of prescribed number of flight-hours when plane might not complete such hours due to sale, grounding, or bankruptcy of owner), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

72. 773 F.2d 1224 (Fed. Cir. 1985), *cert. granted*, 106 S. Ct. 2913 (1986).

73. *See* Rev. Rul. 79-338, 1979-2 C.B. 212; *see also* Priv. Ltr. Ruling 8451003 (June 15, 1984).

74. 534 F.2d 252 (Ct. Cl. 1976).

fact of liability be determined on an item-by-item basis and that the amount of liability be reasonably ascertainable for each individual employee.[75]

The Federal Circuit permitted accrual of the deduction. First, it held that the provision of medical services to the employees was the liability establishing event.[76] In affirming the Claims Court on this issue, the court pointed to *Kaiser Steel Corp. v. United States*,[77] which had held that amounts reserved to meet uncontested worker's compensation claims met the all events test.[78] It did not explain why the provision of medical services rather than the processing of the claims was the liability fixing event.[79] Presumably, it adopted the Claims Court analysis that the filing and the processing of the claims were essentially ministerial in nature.[80] Second, the Federal Circuit held that determination of the fact and amount of liability need not be made on an employee-by-employee basis. The court distinguished *Eastman Kodak* as involving payroll taxes, which had a ceiling computable only on an item-by-item basis, and as requiring only that the liability be ascertainable, not ascertained, on an individual basis.

Like *Hughes Properties*, *General Dynamics* represents a liberal reading of the all events test. The case went beyond *Kaiser Steel* by permitting accrual when there was no statutorily imposed obligation and beyond cases disallowing accrual of a contractual liability so long as some contingency existed.[81] Although not required by precedent, the result in *General Dynamics* was eminently reasonable. In permitting accrual on an aggregate basis, the Federal Circuit responded to

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75. *Id.* at 258.

76. General Dynamics Corp. v. United States, 773 F.2d 1224, 1226 (Fed. Cir. 1985), *cert. granted*, 106 S. Ct. 2913 (1986).

77. 717 F.2d 1304 (9th Cir. 1983). For analysis of *Kaiser Steel*, see Levey, Cameron & Sciortino, *Kaiser Steel Makes New Strides Toward the Deductibility of Self-Insurance Reserves*, 60 J. TAX 74 (1984).

78. For general discussion of this issue, see Note, *Deductibility of Reserves for Workers' Compensation Losses by Self-Insured Employers*, 32 CASE W. RES. L. REV. 187 (1981).

79. Kaiser Steel Corp. v. United States, 717 F.2d 1304, 1310 (9th Cir. 1983).

80. General Dynamics Corp. v. United States, 6 Cl. Ct. 250, 254 (1984), *aff'd*, 773 F.2d 1224, 1226 (Fed. Cir. 1985), *cert. granted*, 106 S. Ct. 2913 (1986).

81. *See, e.g.*, Brown v. Helvering, 291 U.S. 193, 201 (1934) (no accrual of insurance policy sales commissions that are contingent on continuation of policy); Bennett Paper Corp. v. Commissioner, 699 F.2d 450, 453 (8th Cir. 1983) (no accrual of liability to pay into profit sharing plan when contribution contingent on continued employment); Trinity Constr. Co. v. United States, 424 F.2d 302, 305 (5th Cir. 1970) (no accrual of obligation to pay life insurance premium that was contingent on employee being alive when due). These cases are distinguishable from *General Dynamics* as involving substantive and not merely technical contingencies. *Cf.* United States v. Anderson, 269 U.S. 422, 441 (1926) (allowing accrual of munitions tax when munitions sold, despite fact that tax does not accrue "in a technical legal sense" until assessed and due).

business needs by easing the tax burden on self-insurers.[82]

## III. International Taxation

The Federal Circuit's departure from the Court of Claims' pattern of decisionmaking was most apparent in cases concerning international taxation. The Court of Claims was perceived as critical of executive positions. This perception seems untrue of the Federal Circuit, which, in the area of international taxation, adopted broad interpretations supporting official governmental positions.

The first government victory was *Coplin v. United States*.[83] The issue posed in that case was whether Article XV of the United States-Panama Implementation Agreement exempted United States citizens employed by the Panama Canal Commission from United States taxes.[84] The agreement stated flatly that "U.S. citizen employees and dependents shall be exempt from any taxes, fees, or other charges on income received as a result of their work for the Commission. Similarly, they shall be exempt from payment of taxes, fees or other charges on income derived from sources outside the Republic of Panama."[85] After exhaustive analysis, Judge Kozinski of the Claims Court concluded that the treaty exempted United States citizen employees from both United States and Panamanian taxes.[86] First, Judge Kozinski found this to be the plain meaning of the treaty language.[87] Second, he examined the record and found that it included insufficient evidence to overcome that plain meaning.[88] Disagreeing with the government's assertion that Panama lacked an interest in exempting Commission employees from United States taxes, Judge Kozinski described three possible Panamanian policies advanced by a literal reading of the treaty: recognition of the special status of the Canal Commission, promotion of the Panamanian economy by increasing the discretionary income of Americans located there, and retention of American employees by

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82. *See* Levey, Cameron & Sciortino, *supra* note 77, at 76 (aggregate approach permits self-insurers to use more practical and less cumbersome reserving methods, to create more accurate reserve levels, and to accurately forecast future liabilities for incurred but not reported injuries).

For an extensive analysis of *Hughes Properties* and *General Dynamics*, see Jensen, Hughes Properties *and* General Dynamics*: The Supreme Court, the All Events Test and the 1984 Tax Act*, 32 TAX NOTES 911 (Sept. 1, 1986).

83. 761 F.2d 688 (Fed. Cir. 1985).

84. *Id.* at 690.

85. *See* U.S./Panama T.I.A.S. No. 10031.

86. Coplin v. United States, 6 Cl. Ct. 115, 127 (1984), *rev'd*, 761 F.2d 688 (Fed. Cir. 1985), *aff'd sub nom.* O'Connor v. United States, 107 S. Ct. 347 (1986).

87. *Id.* at 126-27.

88. *Id.* at 126.

the Commission.[89] Finally, Judge Kozinski emphasized that the government had introduced no evidence of Panama's intent regarding the treaty.[90]

A five judge panel of the Federal Circuit reversed Judge Kozinski's decision.[91] The morning of the oral argument, the government submitted to the court a diplomatic note, accompanied by letters from members of the Panamanian negotiating team, stating that the treaty was not intended to affect United States taxation of its citizen employees.[92] The opinion of the court denied a motion to strike the submission and, in a single paragraph, found that both parties to the treaty intended no exemption for United States citizen from United States taxation.[93] In a concurring opinion, three judges stated that the late submission was unnecessary to their decision; that a complete reading of the record indicated that the Treaty and Implementation Agreement Article XV governed only Panamanian taxation of United States employees.[94]

The result reached in *Coplin* accords with common sense. Judge Kozinski's arguments notwithstanding, it is difficult to believe that Panama would negotiate an exemption from United States taxes for United States Canal Zone employees. *Coplin* also, however, presents substantial issues concerning admission of extra-record evidence and treaty interpretation. The thorniness of these issues is suggested by *Harris v. United States*,[95] in which the Ninth Circuit reached conclusions opposite from those of the Federal Circuit by refusing to consider the diplomatic note and holding that the treaty unambiguously exempted the employees from United States taxation.[96] Nonetheless, the Federal Circuit summarily disposed of the case. In doing so, the court looked beyond the record and past technical language to reach a common sense position that also comported with the official government position.

A similarly deferential attitude was evident in *Thomas International Ltd. v. United States*,[97] which involved the validity of a Treasury regulation issued under the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code.[98] To encourage

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89. *Id.* at 132-33.
90. *Id.* at 146-48.
91. Coplin v. United States, 761 F.2d 688 (Fed. Cir. 1985), *aff'd sub nom.* O'Connor v. United States, 107 S. Ct. 347 (1986).
92. *Id.* at 691.
93. *Id.* at 691-92.
94. *Id.* at 692 (Nies, J., concurring).
95. 768 F.2d 1240 (9th Cir. 1985).
96. *Id.* at 1242.
97. 773 F.2d 300 (Fed. Cir. 1985).
98. *See* I.R.C. §§ 991-995 (1982). The DISC provisions have been replaced by those au-

exports, these provisions defer tax on DISC income.[99] For a corporation to qualify as a DISC, at least ninety-five percent of its assets must be "qualified export assets," defined by the statute as including "accounts receivable . . . which arise by reason of [export] transactions of such corporation."[100] At issue in *Thomas* were interpretative regulations stating that a trade receivable representing commissions from a related supplier to a DISC would be treated as a qualified export asset only if paid within sixty days of the close of the DISC's taxable year.[101] In *Thomas*, a corporation organized to qualify as a DISC sought to have commissions receivable from a related supplier treated as qualified export assets even though not paid within sixty days of the close of the would-be DISC's taxable year.[102]

The Claims Court held the regulation invalid as adding a condition to the statute.[103] Following the Tax Court,[104] the Second Circuit,[105] and the Eleventh Circuit,[106] the Federal Circuit reversed the Claims Court. The Federal Circuit reasoned that the term "accounts receivable" did not unambiguously include commissions paid.[107] It went on to find the sixty-day payment rule to be "a reasonable requirement the Commissioner validly imposed as a condition of permitting DISCs to include commissions due from related producers in their qualified export assets as accounts receivable."[108] The court observed that if no deadline were imposed upon the payment of commissions receivable, unpaid commissions could be used to circumvent the limitations placed upon producer loans to DISCs: producer loans could be disguised as indefinitely deferred commission receivables.[109]

The analysis in *Thomas* is highly questionable. First, it is difficult to find the perceived ambiguity in the term "accounts receivable." The term "accounts receivable" would, in normal usage, clearly in-

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thorizing Foreign Sales Corporations ("FSC"). *See* Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494, 985 (1984) (codified at §§ 921-927 (1984)).

99. *See* I.R.C. § 921(d) (1984).

100. I.R.C. § 993(b)(3) (1984).

101. *See* Treas. Reg. § 1.993-2(d)(2), 1.994-1(e)(3)(i) (1984).

102. Thomas Int'l Ltd. v. United States, 773 F.2d 300, 301 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 1261 (1986).

103. *See* Thomas Int'l Ltd. v. United States, 6 Ct. Cl. 414, 421 (1984), 773 F.2d 300 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 1261 (1986).

104. *See* CWT Farms, Inc. v. Commissioner, 79 T.C. 1054, 1070 (1982).

105. *See* LeCroy Research Sys. Corp. v. Commissioner, 751 F.2d 123, 128 (2d Cir. 1984).

106. *See* CWT Farms, Inc. v. Commissioner, 755 F.2d 790, 804 (11th Cir. 1985), *cert. denied*, 106 S. Ct. 3271 (1986).

107. Thomas Int'l Ltd. v. United States, 773 F.2d 300, 304 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 1261 (1986).

108. *Id.* at 304-05.

109. *Id.* at 305.

clude a receivable for services rendered. Second, the purported ambiguity does not support the regulation adopted. The Code is silent, not ambiguous, with respect to the time of payment, and, in fixing a time for payment, the regulation adds a new condition to the statutory language. The strongest argument for the regulation is ease of enforcement. The sixty-day payment rule provides an easy litmus test for separating true commissions receivable from fictitous commissions receivable. But the open ended statutory language does not require (and is probably at odds with) that test.[110]

## IV. TAXATION OF TAX-EXEMPT ENTITIES

A distinctive pattern emerges from the partnership taxation, income tax accounting, and international taxation cases: a tendency to reach conclusions different from those reached by other circuits, to read statutory terms broadly, and to uphold Treasury regulations that add to literal statutory language. These elements are present in the two cases decided in 1985 dealing with tax exempt entities.

In *American Bar Endowment v. United States*,[111] the Federal Circuit displayed its independence. In that case, the American Bar Endowment (Endowment), a section 501(c)(3) organization, obtained a group life insurance policy for its members, who in turn assigned the Endowment their dividends under the policy.[112] Two issues were presented. The first was whether income derived from the program constituted "unrelated business taxable income"[113] to the Endowment. Relying on the staggering profit margin of the program, its long term fundraising motivation, and the ABA members' consent to and approval of it, Judge Kozinski of the Claims Court had held that the Endowment's insurance program did not operate in a "competitive, commercial manner" within the meaning of *Disabled Veterans v. United States*,[114] and therefore did not constitute a trade or business.[115] He had also noted that because the amounts received from the program exceeded the value of the services provided by the Endowment, the money had not been earned "from the

110. For comprehensive analysis of *Thomas*, see Comment, Thomas International, Ltd. v. United States: *Regulations in DISCord*, 38 TAX LAW. 715 (1984).

111. 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

112. *Id.* at 1574.

113. I.R.C. § 512(a) (1984).

114. 650 F.2d 1178 (Fed. Cir. 1981) (per curiam).

115. *See* American Bar Endowment v. United States, 4 Ct. Cl. 404, 409 (1984) (quoting Disabled Am. Veterans v. United States, 650 F.2d 1178, 1187 (Fed. Cir. 1981) (per curiam)), *aff'd in part, rev'd in part*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986). *See also id.* at 408-14 (describing operation of Endowment).

sale of goods or the performance of services."[116]

On appeal, Judge Davis affirmed Judge Kozinski's opinion.[117] In doing so, he first distinguished the case from those in the Fourth, Fifth, and Sixth Circuits that had held that income derived from group insurance plans constituted unrelated business income to tax-exempt organizations.[118] He rested this distinction on two grounds: first, that the Endowment was a charitable organization rather than a business league; and second, that the Endowment received its income from experience dividends that its members allowed it to keep rather than from stipends for services provided.[119] Judge Davis also noted that the Endowment did not compete directly with commercial enterprises because it employed commercial underwriters and brokers and did not attempt to undersell other plans.[120]

Judge Davis next dismissed the government's claim that, by setting its rates according to the rate for other insurance in order to maximize receipts, the Endowment operated in a "competitive, commercial" manner.[121] He said that an intent to maximize revenue alone was not dispositive of exempt status, but that the "source and character" of the funds must also be considered.[122] The judge then found that since the proceeds exceeded by far the value of any services which the Endowment might have performed in administering the plan, they were not received pursuant to a commercial exchange, and therefore did not constitute "profits" for purposes of the tax on unrelated business taxable income. He concluded, "[a] charity should not be subject to taxation merely because its charitable solicitations are successful."[123]

The Federal Circuit opinion on the unrelated business taxable income issue does not withstand rigorous legal analysis. Its grounds for distinguishing the opinions of the Fourth, Fifth, and Sixth Circuits are unpersuasive. First, the statutory definition of unrelated business income does not vary between charities and business leagues. Second, funding through payment of stipends rather than

116. American Bar Endowment v. United States, 4 Ct. Cl. 404, 411 (1984) (quoting § 513(c)), *aff'd in part, rev'd in part*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

117. American Bar Endowment v. United States, 761 F.2d 1573, 1583 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

118. *See, e.g.*, Professional Ins. Agents of Mich. v. Commissioner, 726 F.2d 1097, 1104 (6th Cir. 1984); Carolinas Farm Power Equip. Dealers v. United States, 699 F.2d 167, 171 (4th Cir. 1983); Louisiana Credit Union League v. United States, 693 F.2d 525, 534 (5th Cir. 1982).

119. American Bar Endowment v. United States, 761 F.2d 1573, 1578 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

120. *Id.* at 1577.

121. *Id.* at 1578.

122. *Id.*

123. *Id.*

the assignment of experience dividends should make no difference when, as here, each participant was required to assign his experience dividends as a condition of receiving insurance. Finally, the use of underwriters and brokers at the wholesale level and the policy of not undercutting competitor's prices does not prove that the Endowment did not compete effectively with retail brokers.

The Federal Circuit's opinion also misapplied the "competitive, commercial manner" test. In adopting that standard instead of a profit motive test, the *Disabled Veterans* court was concerned that the mailing of low cost articles incidental to the solicitation of far more valuable charitable contributions might give rise to a trade or business.[124] Such concern was not implicated in *American Bar Endowment* because the insurance received by the Endowment's policyholders was worth roughly what they paid for it.[125]

Nor did the facts recited by the Federal Circuit differentiate the program from a commercial enterprise. The fact that the receipts vastly exceeded the value of the Endowment's administrative services did not mean that participants contributed such excess with no expectation of return. By taking advantage of the low insurance risk of its participants, the Endowment could negotiate more favorable insurance terms than those generally available to the public.[126] Whether characterized as a good or a service, this advantage inured to the participants and was indistinguishable from benefits sold by commercial entities. Nor did the right of the ABA membership as a whole to refund premiums change the commercial character of the operation. Each participant was required to assign his dividend in order to obtain coverage, and even acting together, the participants could not have changed the premium assignment policy because they comprised less than twenty percent of the ABA membership. Finally, the alleged lack of actual competition did not make the program less business-like.[127]

In ruling as it did, the Federal Circuit carved out a new exception from the tax on unrelated business taxable income. Perhaps, as a matter of policy, charitable organizations should be able to adhere to long-established fundraising programs without incurring that

124. *See* Disabled Am. Veterans v. United States, 650 F.2d 1178, 1185-87 (Fed. Cir. 1981).

125. American Bar Endowment v. United States, 4 Ct. Cl. 404, 412 & n.10 (1984) (finding that Endowment's rates for insurance were within competitive range in market, at least for some potential buyers), *aff'd in part, rev'd in part*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

126. *Id.* at 407.

127. Disabled Am. Veterans v. United States, 650 F.2d 1178, 1187 (Fed. Cir. 1981) ("Sections 511-13 do not confine [unrelated business taxable income] to those situations where it is established that some specific aspect of unfair competition has occurred.").

tax.[128] Unfortunately, the statute currently taxes such activities so long as they constitute a trade or business, are regularly carried on, and are not substantially related to the organization's exempt functions.[129]

The second issue in *American Bar Endowment* was whether policyholders could deduct the assigned dividends as charitable contributions.[130] In disallowing such deductions, Judge Kozinski required that each donor show "that an equivalent insurance product was available to him for a lower price and that he bypassed that product because he wished to make a charitable contribution to the Endowment."[131] Judge Davis disagreed with Judge Kozinski's formulation of the standard and stated that the question posed was "whether the transaction between the Endowment and the taxpayers involving the assignment of dividends was of a business nature and not charitable,"[132] a determination that must flow from consideration of both the value of the insurance received and factors such as overall purpose and donative intent.[133] Judge Davis noted that charitable intent might be absent for those policyholders who attempted to evade the assignment obligation, but present for participants who wished to meet their insurance needs while supporting a charitable cause.[134] Accordingly, the latter group of policyholders might establish a prima facie case for deductibility by testifying as to their charitable intent.[135]

The court's broad construction of the deduction for charitable contributions lacks foundation in law. In its formulation of the issue, the court neglected to mention that the mere desire to support a charity does not qualify a payment as a charitable contribution. To make a charitable contribution, a donor must have "no expectation of a financial return commensurate with the amount of the

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128. Without explanation, Judge Kozinski assumed that fundraising programs are not subject to unrelated business income taxation. *See* American Bar Endowment v. United States, 4 Ct. Cl. 404, 409 (1984) (describing fundraising activities as not taxable), *aff'd in part, rev'd in part*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986); *id.* at 409-10 (attaching weight to perception of program as fundraising program); *id.* at 412 (assuming that fundraising is not trade or business).

129. *See* Treas. Reg. § 1.513-1(a) (1967).

130. American Bar Endowment v. United States, 761 F.2d 1573, 1575 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

131. American Bar Endowment v. United States, 4 Ct. Cl. 404, 416 (1984), *aff'd in part, rev'd in part*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 106 S. Ct. 2426 (1986).

132. American Bar Endowment v. United States, 761 F.2d 1573, 1582 (Fed. Cir. 1985) (quoting Singer Co. v. United States, 449 F.2d 413, 424 (Ct. Cl. 1971)), *rev'd*, 106 S. Ct. 2426 (1986).

133. *Id.* at 1582 n.9.

134. *Id.* at 1582.

135. *Id.*

gift."[136] A mere donative intent is not enough. Moreover, because of the difficulty of valuing life insurance, a participant cannot be assumed to have had no expectation of a commensurate financial return, absent a showing that he knew that a better deal was available.

In *Greenacre Foundation v. United States*,[137] the Federal Circuit read a statutory term broadly in order to uphold a Treasury Regulation. In that case, the Greenacre Foundation (Foundation) received, by donation, securities that it sold immediately upon receipt. The securities were never intended for use for the production of interest, dividends, rents or royalties, and no such income was received by the Foundation with respect to them.[138] Nevertheless, the government asserted that proceeds from those sales constituted "investment income" for purposes of the excise tax on net investment income of tax-exempt private foundations.[139] According to the relevant statute, investment income included gains and losses from the sale or disposition of "property used for the production of interest, dividends, rents, and royalties."[140] The Treasury regulation interpreting this statutory language provided that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties or capital gains through depreciation (for example, rental real estate, stocks, bonds, mineral interests, mortgages, and securities)."[141] The Foundation challenged the validity of this regulation.

Agreeing with the Tax Court's opinion in *Friedman Foundation v. Commissioner*,[142] the Federal Circuit upheld the regulation. It noted first that the word "used" was ambiguous, referring sometimes to

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136. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4018, 4180; S. REP. No. 1667, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4831. *See* Grinslade v. Commissioner, 59 T.C. 566, 574 (1973) (test for determining whether conveyance constitutes charitable contribution is "whether the 'gift' was made in 'expectation of the receipt of certain specific direct economic benefits within the power of the recipient to bestow directly or indirectly, which otherwise might not be forthcoming' ") (quoting Stubbs v. United States, 428 F.2d 885, 887 (9th Cir. 1970)).

137. 762 F.2d 965 (Fed. Cir. 1985).

138. *Id.* at 966.

139. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 498 (1969) (codified at I.R.C. § 4940).

140. I.R.C. § 4940(c)(4)(A).

141. Treas. Reg. § 53.4940-1(f)(1).

142. 71 T.C. 40 (1978). *See also* Zemurray Found. v. United States, 687 F.2d 97, 99-102 (5th Cir. 1982) (upholding Treas. Reg. § 53.4940-1(f)(i)). For analysis of *Friedman*, see Richardson and Jewitt, *Is Stock Donated to a Foundation and Resold Right Away a Taxable Investment Asset?*, 50 J. TAX'N 110 (1979).

actual use and sometimes to potential or normal use.[143] The court was not troubled by the fact that other portions of the regulation employed the word "used" to mean actually used because those portions were referring to "used" as contained in other portions of the Code.[144] Instead, the court emphasized that the taxpayer's reading of the statute would lead to an "eccentric result," under which a particular stock would be included in the excise tax base simply because the taxpayer fortuitously received a dividend during the holding period.[145] The court also noted that the Treasury's interpretation required little effort to administer because it did not involve individual inquiries into the facts of each case.[146]

In *Greenacre Foundation*, the Federal Circuit read the statutory language broadly. The term "used" may include "held for use" but hardly means merely "susceptible to use."[147] Moreover, the court's fear of an "eccentric result" was unfounded. The rejection of a per se rule that securities are always used for the production of income does not require adoption of a rule that would characterize stock as "used" for the production of income simply because it paid a dividend while held by the foundation. Use could be determined by reference to the taxpayer's intent in holding the securities, as determined by an inquiry into the relevant facts and circumstances.[148] The result in *Greenacre Foundation* was not compelled by language or reason, but represents an acquiescence to an easily administered rule.

## V. TAXATION OF COOPERATIVES AND INSURANCE COMPANIES

Decisions rendered in the areas of the taxation of cooperatives and insurance companies echoed the themes of broad construction of statutory terms and of substance over form. In *Cotter and Co. v. United States*,[149] the taxpayer, a cooperative, earned interest from investing in short-term commercial paper and certificates of deposit,

143. Greenacre Found. v. United States, 762 F.2d 965, 967 (Fed. Cir. 1985).

144. *Id.* at 968.

145. *Id.* at 967-68.

146. *Id.* at 968.

147. *See* Zemurray Found. v. United States, 687 F.2d 97, 103 (5th Cir. 1982) (Gee, J., dissenting) ("[t]here is nothing ambiguous about the word 'used' and it simply does not mean 'usable.'"), 509 F. Supp. 976, 979-80 (E.D. La. 1981) ("'used' in its ordinary sense means actually used").

148. Indeed, this may have been the rule prior to the promulgation of Treas. Reg. § 59.4940-1(f)(1). *Cf.* Rev. Rul. 74-404, 1974-2 C.B. 382 (prior to effective date of regulation, proceeds from donated stock sold immediately after receipt not subject to excise tax on net investment income).

149. 765 F.2d 1102 (Fed. Cir. 1985).

and rent from leasing temporarily excess warehouse space.[150] The question raised was whether such earnings were from business done "with or for"[151] patrons,[152] and therefore eligible for treatment as patronage dividends.[153] The relevant Treasury regulation defined nonpatronage sourced income as "incidental income derived from sources not directly related to the marketing, purchasing, or service activities" of the cooperative, and listed income derived from the lease of premises and investment in securities as examples of such income.[154] Looking to whether each transaction "facilitated the basic purchasing, marketing, or service activities" of the cooperative, rather than simply enhancing its overall profitability, the Claims Court determined that the rental and interest income in question was not patronage sourced.[155]

The Federal Circuit reversed the Claims Court. In doing so, it refused to focus narrowly upon whether the income producing operations facilitated the taxpayer's cooperative functions. Rather, it stated that the inquiry into whether the income was directly related to the cooperative's marketing, purchasing, or service activities "must be undertaken by viewing the business environment to which it is arguably related."[156] The court then determined that the interest and rental income at issue were directly related to the cooperative's function. Because that function required large amounts of capital and necessarily generated a temporary surplus of funds, the cooperative acted reasonably in preserving its liquidity by investing in commercial paper and certificates of deposit.[157] The existence of alternative means for retaining liquidity did not make these investments less directly related.[158] Likewise, the rentals, which were only a minor component of the taxpayer's plan for assuring sufficient warehouse space, were patronage sourced.[159]

Like the accounting cases, *Cotter* is more noteworthy for its result than its reasoning. The court's broad reading of the "directly related" test stretches considerably the concept of transactions con-

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150. *Id.* at 1104.

151. I.R.C. § 1388(a) (1976).

152. Cotter and Co. v. United States, 765 F.2d 1102, 1103 (Fed. Cir. 1985).

153. *See* I.R.C. § 1382(b)(1) (1976) (patronage dividends, to extent paid in money, not taken into account in determining taxable income of cooperative).

154. Treas. Reg. § 1.1382-3(c)(2).

155. *See* Cotter and Co. v. United States, 6 Ct. Cl. 219, 228-31 (1984), *rev'd*, 765 F.2d 1102 (Fed. Cir. 1985).

156. Cotter and Co. v. United States, 765 F.2d 1102, 1106-07 (Fed. Cir. 1985).

157. *Id.* at 1107.

158. *Id.* at 1109.

159. *Id.* at 1109-10.

ducted "with or for" patrons.[160] By attaching weight to the business needs of the taxpayer, the Federal Circuit blurred the line between patronage sourced and nonpatronage sourced income. Yet, such blurring may be inevitable in a world that demands that opportunity costs be minimized. By holding as it did in *Cotter*, the Federal Circuit acknowledged that business income seldom falls into vacuum tight categories.

The doctrine of substance over form prevailed in *Massachusetts Mutual Life Insurance Co. v. United States.*[161] There, an insurance company sustained a loss on a loan made to an oil company by it and two other financial institutions.[162] The issue posed was whether the loss was attributable to a business other than insurance and therefore deductible from taxable investment income under section 804.[163] The insurance company argued that it was a member of a partnership created to arrange the loan, and that the partnership was not engaged in the insurance business.[164] Observing that the taxpayer conceded that the loss would not be deductible if the loan were made by it alone, the court rejected this argument, reasoning that there was no reason why Congress would deny the deduction for a loan made by a single insurance company, but grant the deduction for a loan made in concert.[165] To support its conclusion, the court cited legislative history and treasury regulation.[166]

*Massachusetts Mutual* displayed appreciation of the doctrine of substance over form. The character of a business transaction cannot always be changed simply by adding more parties. By recognizing this fact, the Federal Circuit focused clearly on economic reality.

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160. The previous circuit authority finding that interest income met the directly related test was St. Louis Bank for Cooperatives v. United States, 624 F.2d 1041 (Ct. Cl. 1980), which held that interest earned by a banking cooperative was patronage sourced. The Service limited that case to cooperatives providing financial services. *See* Priv. Ltr. Ruling 8130001.

In other contexts, a need for liquidity has been recognized as providing sufficient grounds for relief from an otherwise applicable tax statute. For example, debt incurred in order to meet a need for liquidity has been held not "incurred or continued to purchase or carry" tax exempt obligations within the meaning of section 265(2). *See* Swenson Land & Cattle Co. v. Commissioner, 64 T.C. 686, 698 (1975); Handy Button Mach. Co. v. Commissioner, 61 T.C. 846, 853 (1974).

161. 761 F.2d 666 (Fed. Cir. 1985).

162. *Id.* at 667.

163. *Id.* at 668; *see* I.R.C. § 804(c)(5) (1983) (permitting deduction for expenses "attributable to any trade or business (other than an insurance business) carried on by a life insurance company, or by a partnership of which the life insurance company is a partner").

164. Massachusetts Mut. Life Ins. Co. v. United States, 761 F.2d 666, 669 (Fed. Cir. 1985).

165. *Id.* The court also cryptically stated that if the partnership were regarded as engaged in a trade or business different from its partners because it was a distinct entity from them, the loss would also be "incurred by the partnership as a separate entity." *Id.*

166. *Id.* at 669-71.

## VI. DEFINITION OF INCOME AND WAGES

The Federal Circuit also issued several less important decisions lacking its distinctive flavor. Two of these concerned the definition of "income" and "wages." In *Wheeler v. United States*,[167] the court determined that amounts paid by a trust created by the taxpayers' employer to the taxpayers' children constituted taxable compensation despite the fact that payments were made directly to the children.[168] In *Incorporated Trustees of the Gospel Workers Society v. United States*,[169] the court held that meals and lodgings furnished to employees who could have adequately performed their duties without those benefits constituted "wages" under the Federal Insurance Contributions Act.[170] Involving well established principles, neither *Wheeler* nor *Gospel Workers* afforded the Federal Circuit the room necessary to engage in its peculiar brand of decisionmaking.[171]

## CONCLUSION

As seen above, the Federal Circuit's 1985 opinions had a distinctly equitable flavor. The court tended to take a larger perspective, relying more on common sense than upon technical argument. It was willing to read language broadly, give words contextual meanings, and consider commercial needs. This pattern harkens back to the Court of Claims, which is not surprising considering that nine of the thirteen opinions were authored by former judges of that court. Unlike the Court of Claims, the Federal Circuit deferred to Treasury regulations. This deference may not, however, signal a departure from Court of Claims' practice since it occurred when necessary to reach an equitable end. Thus, the Federal Circuit seemed more a court of equity than a renegade or taxpayer court.[172]

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167. 768 F.2d 1333 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 850 (1986).
168. *Id.* at 1335.
169. 777 F.2d 1552 (Fed. Cir. 1985).
170. *Id.* at 1556.
171. The only other tax decision issued by the Federal Circuit in 1985 was Wilmington Trust Co. v. United States, 753 F.2d 1055 (Fed. Cir. 1985) (affirming Claims Court's determination that, under Texas law, income derived during marriage from certain trusts constituted separate property of surviving spouse and therefore was not includible in estate of decedent spouse).
172. This pattern is remarkably uniform throughout the circuit. The ten important tax opinions were spread among six judges. The three judges who wrote more than two opinions all coupled cases displaying equitable attitudes with those deferring to official governmental positions. *Compare* Holiday Village Shopping Center v. United States, 773 F.2d 276 (Fed. Cir. 1985) (Judge Friedman adding to literal terms of Code) *with* Thomas Int'l Ltd. v. United States, 773 F.2d 300 (Fed. Cir. 1985) (Judge Friedman deferring to easily administered regulation), *cert. denied*, 106 S. Ct. 1261 (1986). *Compare* General Dynamics Corp. v. United States, 773 F.2d 1224 (Fed. Cir. 1985) (Judge Bissell reading statute broadly), *cert. granted*, 106 S. Ct. 2913 (1986) *with* Coplin v. United States, 761 F.2d 688 (Fed. Cir. 1985) (Judge Bissell deferring to executive interpretation of treaty), *cert. granted sub nom.* O'Connor v. United States, 106

What is the source of this pattern? Three institutional factors may have fostered the court's peculiar, equitable style. One is the judges' relative familiarity with tax law. Although tax cases make up one hundred percent of the tax court docket and five percent of the district court docket, they constitute thirty percent of the Court of Claims docket.[173] Thus, former Court of Claims judges have a unique perspective vis-'a-vis judges of other courts: they are familiar with, but not immersed in, tax law. Depending on one's attitude, this perspective could be a plus or a minus. The court might be praised as one that does not lose sight of the forest for the trees, or it might be condemned as proof of the adage that a little knowledge is a dangerous thing.

A second factor is the court's need to justify its role in adjudicating federal tax issues. The Federal Circuit's concurrent jurisdiction over refund claims serves no purpose if its opinions are indistinguishable from those of other circuits. Consequently, the Federal Circuit has an incentive to set itself apart from other courts by adopting a unique judicial style.

The third factor is forum shopping. Taxpayers who cannot afford to pay their assessment must go to Tax Court. Those who can pay will generally find the district court more convenient. Thus, the tax cases reaching the Federal Circuit are different from those considered by other courts. First, Federal Circuit cases have larger amounts in controversy,[174] a fact that permits taxpayers to spend more time and energy developing creative legal theories. Second, they present situations that play upon the court's natural sympathies—cases with appealing equitable arguments. Litigants do not come to the Federal Circuit by accident; they come in search of a distinctive jurisprudence. And, as the 1985 tax cases demonstrate, they frequently receive it.

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S. Ct. 784 (1986). *Compare* American Bar Endowment v. United States, 761 F.2d 1573 (Fed. Cir. 1985) (Judge Davis exempting fundraising programs from tax on unrelated business taxable income), *rev'd*, 106 S. Ct. 2426 (1986) *with* Greenacre Found. v. United States, 762 F.2d 965 (Fed. Cir. 1985) (Judge Davis deferring to easily administered regulation).

173. *See* Peartree, *Statistical Analysis of the Court of Claims*, 55 GEO. L.J. 541, 541 (1966); Telephone Interview with Roger Nieman, Chief Deputy Clerk, United States Claims Court (June 19, 1986) (tax cases made up 32-34% of Court of Claims docket from 1979-1982).

174. *See* Pavenstedt, *supra* note 1, at 211.