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TAXATION: PRESAGING THE UNITED STATES SUPREME COURT

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The United States Court of Appeals for the Seventh Circuit attracted much attention in the taxation area during its past term.¹ While not hearing a large number of cases,² a few of the cases decided have attracted a fair amount of publicity. This article will first discuss a case³ where the Seventh Circuit concluded that a long-standing dictum of the United States Supreme Court⁴ was no longer good law. The dictum provided that a grant by a corporation to its shareholders of rights to purchase its property cannot constitute a dividend because the mere grant of rights does not diminish the assets of the corporation. Second, this article will focus on a case⁵ which touched on the question of whether it is proper to look to the partnership's trade or business or to each individual partner's trade or business in determining whether start-up expenses must be capitalized or expensed. Included in this analysis will be those issues which the Seventh Circuit failed to consider and which will affect the precedential impact of a case which al-

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1. This article addresses tax cases decided by the Seventh Circuit during the period June 1, 1980, to May 31, 1981.

2. Tax cases decided this term by the Seventh Circuit other than those discussed in this article include *Fleming v. United States*, 648 F.2d 1122 (7th Cir. 1981) (penalties for late filing of estate tax return); *Fine v. United States*, 647 F.2d 763 (7th Cir. 1981) (deductions for personal use of resort condominium); *Candela v. United States*, 635 F.2d 1272 (7th Cir. 1980) (tax fraud); *Brantingham v. United States*, 631 F.2d 542 (7th Cir. 1980) (inclusion of life estate in gross estate of decedent); *Campagna-Turano Bakery, Inc. v. United States*, 632 F.2d 39 (7th Cir. 1980) (priority of tax liens); *Specia v. Commissioner*, 630 F.2d 554 (7th Cir. 1980) (taxability of income to parents where transfer of stock to children); *United States v. Baskes*, 631 F.2d 733 (7th Cir. 1980) (tax fraud); *United States v. Moore*, 627 F.2d 830 (7th Cir. 1980), *cert. denied*, 450 U.S. 916 (1981) (tax fraud); *Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980) (transfer of property with liabilities in excess of basis).

3. *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981). See text accompanying notes 13-88 *infra*.

4. *Palmer v. Commissioner*, 302 U.S. 63 (1937).

5. *Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980). See text accompanying notes 89-119 *infra*.

ready is being cited.⁶ Third, an Employee Retirement Income Security Act⁷ case⁸ will be analyzed in light of congressional intent in the creation of individual retirement accounts⁹ and of changes enacted by the Economic Recovery Tax Act of 1981¹⁰ which will eliminate the issue in future years. This article concludes with a section on developments in the law which discusses a case involving the tax benefit rule¹¹ and a case concerning the definition of wages for employment tax purposes where the result reached by the Seventh Circuit was approved by the United States Supreme Court.¹²

TAXABILITY OF THE RECEIPT BY SHAREHOLDERS OF RIGHTS TO ACQUIRE CORPORATE PROPERTY

In *Redding v. Commissioner*,¹³ the Seventh Circuit faced one of the more delicate tasks that occasionally confront the appellate courts: that of disposing of a Supreme Court precedent which has long outlived its usefulness but which has never been formally overruled. The precedent in question was the Supreme Court's famous dictum in *Palmer v. Commissioner*¹⁴ that a corporation's grant to shareholders of rights to purchase its property cannot constitute a dividend because the mere grant of rights does not diminish the corporation's assets. Aided by the virtually unanimous opinion of commentators¹⁵ and a broad hint from

6. *Blitzer v. United States*, 1981-1 U.S.T.C. ¶ 9262 (Ct. Cl. 1981). The Tax Court opinion of *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521 (1980), has been cited by *In re Boyd*, 76 T.C. 646 (1981); *Southern Pacific Transp. Co. v. Commissioner*, 75 T.C. 497 (1980); *Goodwin v. Commissioner*, 75 T.C. 424 (1980).

7. Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at 29 U.S.C. §§ 1001-1381 (1976 & Supp. III 1979) and at I.R.C. §§ 401-415) [hereinafter referred to as ERISA].

8. *Foulkes v. Commissioner*, 638 F.2d 1105 (7th Cir. 1981). See text accompanying notes 120-71 *infra*.

9. See I.R.C. § 408 [hereinafter referred to as IRA].

10. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), reprinted in [1981] U.S. CODE CONG. & AD. NEWS 172 [hereinafter referred to as ERTA].

11. *Home Mut. Ins. Co. v. Commissioner*, 639 F.2d 349 (7th Cir. 1980); *Hillsboro Nat'l Bank v. Commissioner*, 641 F.2d 529 (7th Cir. 1981), cert. granted, 50 U.S.L.W. 3570 (Jan. 19, 1982). See text accompanying notes 172-187 *infra*.

12. *Oscar Mayer & Co. v. United States*, 623 F.2d 1223 (7th Cir. 1980). See text accompanying notes 188-223 *infra*.

13. 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981).

14. 302 U.S. 63 (1937).

15. Carlson, *Taxation of 'Taxable' Stock Rights: The Strange Persistence of Palmer v. Commissioner*, 23 TAX. L. REV. 129, 140-43 (1968); Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 YALE L.J. 1016, 1028-31 (1957); Comment, *Taxation of Stock Rights*, 51 CALIF. L. REV. 146, 150-51 (1963) [hereinafter cited as Comment]. See also Gann, *Taxation of Stock Rights and Other Options: Another Look at the Persistence of Palmer v. Commissioner*, 1979 DUKE L.J. 911, 963-64 [hereinafter cited as Gann]; Smith, *Rights Offerings of Portfolio Securities*, 26 TAX LAW. 471 (1973) [hereinafter cited as Smith].

the Supreme Court itself,¹⁶ the Seventh Circuit concluded that *Palmer* had not survived the enactment of the 1954 Code.

However, in addition to deciding that the stock rights received by the Reddings were not insulated from dividend treatment by *Palmer*, the court was required to determine whether the issuance of the rights constituted a taxable event at all, or whether it was an integral part of a tax-free corporate spin-off under section 355. The court elected to address the spin-off issue first, failing to take into account the fact that a determination of the validity of *Palmer* was a necessary prerequisite to analysis of section 355.¹⁷ The result of this backwards analysis is an opinion which properly rid the corporate provisions of the Code of the *Palmer* dictum, but which failed to give a clear indication of how section 355 should be applied without it.

The transaction which led to *Redding* began when the Indianapolis Water Company was requested by the Indiana Public Service Commission to divest itself of its real estate development activities, such activities being deemed inappropriate for a public utility. The water company had a wholly-owned subsidiary, Shorewood Corporation, which was engaged in the ownership and development of the properties surrounding the reservoirs used by the water company. Rather than simply distribute the Shorewood stock to its shareholders, the water company decided to use the transaction to raise additional operating capital. Accordingly, it distributed to its shareholders warrants to acquire one share of Shorewood stock upon the exercise of two warrants and the payment of \$5.00, an amount which was stipulated to be less than the fair market value of the stock. The warrants were to be exercised within fifteen days after their issuance, and during this fifteen day period an over-the-counter market developed in the warrants. The Reddings were shareholders of the water company and received 7,000 warrants, all of which they exercised to receive 3,500 shares of Shorewood.¹⁸ The issue before the court, however, was whether the receipt of the 7,000 warrants constituted a dividend to the Reddings at the time of issuance, regardless of whether the warrants were later exercised,

16. See text accompanying notes 33-34 *infra*.

17. 630 F.2d at 1173.

18. The case of the Reddings was consolidated with that of Thomas and Anne Moses, who were also Water Company shareholders. The Moseses, in addition to exercising their primary subscription rights, also exercised their secondary subscription rights as shareholders to acquire Shorewood stock not subscribed for in the first offering. They thus acquired some 20,000 shares of Shorewood stock. This statement of facts is condensed from the Tax Court's opinion. *Redding v. Commissioner*, 71 T.C. 597, 598-601 (1979).

sold or allowed to lapse.¹⁹

Palmer v. Commissioner *And Its Progeny*

The taxability of warrants at the time of issuance had been precisely the issue addressed by the *Palmer* dictum. In *Palmer*, a corporation had granted to its shareholders, including Palmer, the right to purchase its portfolio shares²⁰ of another corporation. Palmer exercised his right and the actual issue for the Supreme Court was whether he had recognized any income on the exercise of the warrants. However, the Court began its analysis by stating that it was axiomatic that Palmer had not received a dividend when the rights were granted:

The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. . . . They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise.²¹

The Court went on to hold that although a dividend could occur when a right to acquire corporate property was exercised, Palmer had not received a dividend on the exercise of his right. The Court found that the corporation had intended to fix the purchase price of the portfolio stock at its fair market value, and thus the transaction was a bona fide sale between the corporation and its shareholders.²² The Court noted that the fact that the stock was actually worth more than what Palmer paid for it when he exercised his right was the result merely of a market fluctuation rather than a distribution of profits by the corporation.

An elaborate edifice of rules regarding the taxation of rights to acquire corporate property was built upon the foundation of *Palmer*.

19. There is no indication in either the Tax Court's or the Seventh Circuit's opinion that the Service argued in the alternative that income should have been recognized on the exercise of the warrants, which was the issue in the *Baan-Gordon* litigation. See text accompanying notes 48-59 *infra*. In fact, the Moseses acquired 4,000 of their Shorewood shares as agents for a third party. 71 T.C. at 601. This presumably means they sold their warrants, which would be a taxable transaction even under the Tax Court's reading of I.R.C. § 355, but no mention of this is made in the Tax Court's opinion.

20. The term "portfolio shares" is often used in cases involving the *Palmer* issue, and will be used herein to distinguish between a corporation's distribution of rights to acquire the stock of other corporations which it owns and its distribution of rights to acquire its own stock.

21. 302 U.S. at 71 (citations omitted).

22. *Id.* at 73.

In the subsequent case of *Choate v. Commissioner*,²³ the Second Circuit held that the corporate intent to grant a dividend which the Supreme Court found lacking in *Palmer* was to be determined upon an objective basis. The practical effect of this rule was that, if there were a "spread" between the fair market value of corporate property and the exercise price for rights granted to the shareholders to acquire such property at the time the rights were granted, the corporation was conclusively deemed to have intended to grant a dividend. The dividend would not occur, however, until a right was exercised by the shareholder, at which time the amount of the dividend was limited to the lesser of the "spread" on the date the right was granted and on the date the right was exercised.²⁴

The following year, in *Gibson v. Commissioner*,²⁵ the Second Circuit held that if the rights were sold rather than exercised, ordinary income resulted under the assignment of income doctrine.²⁶ Shortly thereafter, the Service set forth its understanding of the principles established by the *Palmer-Choate-Gibson* trilogy in General Counsel Memorandum 25063,²⁷ and a number of cases followed applying these principles in various situations.²⁸

A short time thereafter, Congress undertook a complete revision of the rules governing corporate transactions in what was to become subchapter C of the 1954 Code. It is noteworthy that the committee reports made no reference to the *Palmer* doctrine. Moreover, the rules enacted in subchapter C are at odds with the basic premise of *Palmer*.

23. 129 F.2d 684 (2d Cir. 1942).

24. The court reasoned that if the spread increased before the rights were exercised, the increase was merely due to market fluctuations and not to the corporation's intent to grant a dividend, which was determinative under *Palmer*. On the other hand, the amount of the dividend could not exceed the amount of the spread at exercise, since *Palmer* established that no dividend occurred until that time. 129 F.2d at 687.

25. 133 F.2d 308 (2d Cir. 1943).

26. The doctrine holds generally that a taxpayer cannot avoid being taxed on income after the right to receive it has accrued by transferring the right to another party. See, e.g., *Helvering v. Horst*, 311 U.S. 112, 116 (1940).

27. 1947-1 C.B. 45. G.C.M. 25063 agreed that dividend income was realized at the time of exercise, rather than issuance, of rights to acquire portfolio stock, measured by the spread between exercise price and fair market value. It is silent on the *Choate* issue of whether the amount of the dividend is limited to the lesser of the spread on issuance and exercise, although it expressly states that the entire amount of income received from the sale of a right is ordinary income (an issue which was not resolved in *Gibson*), which is arguably inconsistent with the "lesser of" rule of *Choate*. G.C.M. 25063 also held that no loss is recognized on the lapse of a right, which appears to be correct. See *Eastern Shares Corp. v. Commissioner*, 32 B.T.A. 608 (1935).

28. See, e.g., *Tobacco Prods. Export Corp. v. Commissioner*, 21 T.C. 625 (1954), *nonacq.*, 1955-2 C.B. 11 (proceeds from sale of rights eligible for the predecessor to the dividends received exclusion of I.R.C. § 243); *W.G. Maguire & Co. v. Commissioner*, 20 T.C. 20 (1953) (tax treatment of rights where distributing corporation has no earnings and profits). A good survey of the progeny of *Palmer* can be found in Gann, *supra* note 15.

All of the revenue acts which preceded the 1954 Code, including the Revenue Act of 1928, under which *Palmer* was decided, defined a dividend as "any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913."²⁹ The 1954 Code retained this basic definition of a dividend in section 316(a). However, section 316(a) goes on to provide that any distribution of property to which section 301 applies shall be treated as a distribution of property for purposes of section 316(a) and shall be considered a dividend to the extent that the corporation has earnings and profits at the time the distribution is made. Section 301 provides comprehensive rules for the taxation of distributions of property, referring to section 317(a) for the definition of property. Section 317(a), in turn, provides that property means "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." The specific exclusion of rights to acquire a distributing corporation's stock from the definition of property negatively implies that rights to acquire a corporation's assets in general are property. Furthermore, section 305 sets out specific rules governing the distribution of rights to acquire the corporation's own stock. Such rights are excluded from taxability by section 305(a), unless they fall within one of the exceptions listed in section 305(b). Thus, section 305, like section 317(a), buttresses the notion that the distribution of rights to acquire corporate assets is a distribution of property taxable under section 301.³⁰

Despite these conceptual inconsistencies, the continued validity of *Palmer* was not seriously challenged until the *Baan-Gordon* litigation.³¹

29. Pub. L. No. 70-562, § 115(a), 45 Stat. 791 (1928). The phrase made its debut in the Revenue Act of 1916, Pub. L. No. 64-271, § 2(a), 39 Stat. 756 (1916).

30. See Smith, *supra* note 15, at 474-75, for an argument that Congress' probable reason for excluding distributions of rights to acquire the corporation's own stock from the definition of property in § 317(a) was to avoid any possible overlap with § 305, rather than to overrule *Palmer*. Commentators have also pointed out that the Supreme Court's treatment of rights granted to shareholders is difficult to reconcile with its treatment of stock options granted to employees under *Commissioner v. Smith*, 324 U.S. 177 (1945), and *Commissioner v. LoBue*, 351 U.S. 243 (1956), which are generally interpreted as implying that an option with a readily ascertainable fair market value may be taxable as compensation when granted, rather than when exercised. See Gann, *supra* note 15, at 941-47. The principles of *Smith* and *LoBue* are now codified in I.R.C. § 83. See note 41 *infra*.

31. *Baan v. Commissioner*, 45 T.C. 71 (1965), *rev'd*, 382 F.2d 485 (9th Cir. 1967), and *aff'd in part and rev'd in part sub nom. Commissioner v. Gordon*, 382 F.2d 499 (2d Cir. 1967), 2d Cir. *rev'd* and 9th Cir. *aff'd sub nom. Commissioner v. Gordon*, 391 U.S. 83 (1968), *on remand*, *Baan v. Commissioner*, 51 T.C. 1032 (1969), *aff'd per curiam*, 450 F.2d 198 (9th Cir. 1971), and *aff'd sub nom. Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970). This monumental piece of litigation is discussed in the text at notes 48-59 *infra*.

The litigation, which is discussed in detail below, involved the qualification of a spin-off under section 355 similar to the *Redding* transaction, except that the Service, assuming the validity of *Palmer*, assessed a tax on the exercise, rather than on the issuance, of the warrants. *Baan-Gordon* culminated in the Supreme Court.³² The Court began its opinion by noting that it was clear that a distribution of property had taken place no later than the date on which the stock warrants were exercised, which distribution, unless protected by section 355, was a dividend.³³ Since the Commissioner had not contended that a dividend occurred earlier, this was as far as the Court needed to go in order to decide the case. However, in a footnote, the Court observed that in *Palmer* there had been no difference between the fair market value of the stock involved and the exercise price of the warrants at the time the warrants were issued. The question of whether a dividend would result if such a spread existed, the Court stated, had never been authoritatively settled.³⁴

The Court's treatment of the fundamental premise of its *Palmer* analysis as mere dictum and its failure to mention the effect of the intervening enactment of the 1954 Code were somewhat disingenuous. Nevertheless, the message was clear that the Court would be receptive to abandoning *Palmer* and the Service was quick to take the hint by issuing Revenue Ruling 70-521³⁵ stating that it would regard *Palmer* as having been overruled by the enactment of the 1954 Code.

Following *Baan-Gordon* and Revenue Ruling 70-521, the Fifth Circuit, in *Baumer v. United States*,³⁶ held that a closely-held corporation which distributed to its sole shareholder's son an option to acquire certain real estate which could be expected to appreciate substantially during the option period had made a constructive dividend. The Fifth Circuit acknowledged the force of the argument that *Palmer* should be considered to have been overruled by the 1954 Code, but, in light of the substantial differences between the stock rights involved in *Palmer* and the real estate option involved in *Baumer*, the court restricted itself to stating that *Palmer* should be limited to its facts.³⁷ In light of these developments, and a substantial body of commentary rejecting the continuing validity of *Palmer*,³⁸ the Seventh Circuit had no difficulty in

32. 391 U.S. 83 (1968).

33. *Id.* at 89.

34. *Id.* at 89 n.4.

35. 1970-2 C.B. 72.

36. 580 F.2d 863 (5th Cir. 1978).

37. *Id.* at 879.

38. See note 15 *supra*.

taking the final step and declaring that *Palmer* should no longer be followed.

Assuming that the Seventh Circuit's conclusion regarding *Palmer* is generally followed, the consequences of *Redding* are extensive but fairly easy to predict. Subchapter C contains detailed rules governing the taxation of corporate distributions of property which are triggered by the finding that rights to acquire corporate assets, such as the warrants involved in *Redding*, are "property."³⁹ In essence, *Redding* will bring the taxation of rights distributions in line with distributions of other types of property.⁴⁰ Although this will cause some administrative problems in that it will require the valuation of such rights at the time they are granted, valuation problems are common in tax law and in this case are an acceptable price to pay in order to achieve a consistent treatment of corporate distributions under subchapter C.⁴¹

39. In general, I.R.C. § 301 provides the general rule that distributions first, are includable in income to the extent they constitute dividends; second, they constitute a return of capital to the extent of the shareholder's basis in his stock; and finally, they are treated as a gain from the sale or exchange of stock. Section 302 deals with the situations in which a distribution in redemption of stock is treated as a capital gain, I.R.C. §§ 331-334 deal with distributions in liquidation of the corporation, and I.R.C. §§ 354-358 provide special rules dealing with reorganizations. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 7.20, 9.20, 11.03, 14.10 (4th ed. 1979 & 1981 Supp.) [hereinafter cited as Bittker & Eustice].

40. See Gann, *supra* note 15, at 964.

41. The problem of valuation is, of course, present whenever property other than cash (or publicly traded securities) is distributed. However, the valuation problem is particularly acute in the case of rights and options, in that the value of such rights is dependent not only on the difference between the fair market value of the property involved and the exercise price, but also upon the term during which the right can be exercised. Thus, a right to acquire property at the property's fair market value may have an independent value if the exercise price will remain fixed during a period in which the value of the property may appreciate. Section 83, which deals in part with the grant of stock options to employees as compensation, provides that such options are includable in income when granted only if the options have a readily ascertainable fair market value. I.R.C. § 83(e)(3). The regulations take a very narrow approach to this problem, providing in essence that a stock option generally has a readily ascertainable fair market value only if the option itself is publicly traded. Treas. Reg. § 1.83-7(b). This rule can work to the disadvantage of employees, who may wish to have the value of an option included in their taxable income as compensation when the option is granted, so that any future appreciation in value will constitute capital gain. In fact, the legislative history of the Tax Reform Act of 1976 directs the Service to develop more flexible rules for valuing options, but no rules have yet been promulgated. See H. Conf. Rep. No. 1515, 94th Cong., 1st Sess. 438 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4147.

In the case of options or rights granted to shareholders, there is no statutory equivalent to I.R.C. § 83. However, the Fifth Circuit in *Baumer v. United States*, 580 F.2d 863 (5th Cir. 1978), reached a similar result through use of the "open transaction" doctrine, under which no income is realized on an otherwise taxable transaction so long as the amount of income to be derived from the transaction is impossible to ascertain. *Id.* at 885. A complete discussion of the open transaction doctrine, and a proposed statutory solution for distributions of stock rights based on the principles of I.R.C. § 83, is in Gann, *supra* note 15, at 958-60 & 974-84.

Section 355

Ironically, one of the areas in which the treatment of rights is left unclear is the area involved in *Redding* itself: tax-free spin-offs under section 355. The basic problem with the Seventh Circuit's analysis of section 355 arises from the order in which it treated the issues raised in the case. The Tax Court, in an effort to avoid directly addressing the validity of *Palmer*, assumed *arguendo* that the distribution of warrants would be a taxable transaction if section 355 were not applicable and proceeded directly to its analysis of section 355. The Seventh Circuit, whether out of deference to a venerable Supreme Court decision or a desire to deal with the issues in the order in which the Tax Court had raised them, also dealt with the section 355 issue first. As a result, both courts treated *Palmer* as relevant only to the issue of whether the issuance of the warrants constituted a dividend. Neither recognized *Palmer* as presenting the more fundamental issue of whether the issuance of the warrants was a distribution of property, the basic event which triggers most of the relevant operative provisions of subchapter C. As a result, the Seventh Circuit approached section 355 with one of its most fundamental terms left undefined.

Section 355 was added to the Code in 1954 in order to provide uniform rules governing the tax-free division of a corporation or controlled corporate group. Prior to 1954, in order to attain tax-free status such divisions had to qualify under the reorganization provisions of the Code, and a considerable body of case law dealing with the distinctions between "spin-offs," "split-offs" and "split-ups" developed.⁴² Under

42. The earliest reorganization provisions of the tax laws provided tax-free treatment for an exchange of stock for stock of other corporations pursuant to a reorganization, merger or consolidation of the corporation. Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057 (1919). Under this provision, a parent corporation could transfer the subsidiary's stock to its shareholders in exchange for a portion of their parent corporation stock (a "split-off") or could transfer all of its assets to two or more subsidiaries and dissolve, with the shareholders receiving the subsidiaries' stock in exchange for their parent corporation stock (a "split-up"). The Revenue Act of 1924 added a new provision, § 203(c), allowing stock to be distributed tax-free pursuant to a reorganization without the surrender of other stock in exchange, which gave rise to the "spin-off". Revenue Act of 1924, Pub. L. No. 68-175, § 203(c), 43 Stat. 253 (1924). In *Gregory v. Helvering*, 293 U.S. 465 (1935), a corporation transferred unneeded assets to a subsidiary and spun the subsidiary off to its sole shareholder who, upon liquidating the spun-off corporation, was able to obtain a distribution of corporate earnings at capital gain rates. Although the Supreme Court, in one of the most famous cases in tax law, ruled that the spin-off was not a reorganization because of the lack of a valid business purpose, Congress, while the case was still on appeal, acted to eliminate the problem by deleting the provision allowing spin-offs entirely from the Revenue Act of 1934 and succeeding acts. No comparable action was taken on split-offs and split-ups, although they would appear to be equally subject to abuse. Spin-offs remained in limbo until the Revenue Act of 1951 added § 112(b)(11) to the 1939 Code, reinstating spin-offs unless either the spun-off subsidiary or the parent was not intended to conduct an active business, or the spun-off stock was used as a "device for the distribution of earnings and profits." Revenue Act of 1951,

section 355, however, when a corporation "distributes to a shareholder, with respect to its stock . . . solely stock or securities"⁴³ of an eighty percent controlled subsidiary,⁴⁴ the shareholders recognize no income on the distribution, provided that three ancillary requirements are met. The requirements are: first, the transaction must not be used principally as a device for distribution of earnings and profits of one of the corporations;⁴⁵ second, the corporation whose stock is distributed must have been engaged in an active trade or business for at least five years;⁴⁶ and third, the distributing corporation must either distribute all of the stock and securities of the spun-off corporation which it owns or an amount of stock constituting "control" under the eighty percent test of section 368(c).⁴⁷

Any analysis of the use of stock warrants in a spin-off must take place in the shadow of *Baan-Gordon*. *Baan-Gordon* arose out of the decision of AT&T to divide Pacific Telephone & Telegraph Company ("Pacific"), which provided telephone services for the west coast, into two separate subsidiaries. Accordingly, AT&T caused Pacific to form a new subsidiary, Pacific Northwest Bell Telephone Company ("Northwest"), to which it transferred all of the assets necessary to conduct the Oregon, Washington and Idaho business, retaining the California business.⁴⁸ Pacific was then to distribute the Northwest stock to its shareholders. Since AT&T owned ninety percent of the stock of Pacific, it would also end up owning ninety percent of the stock of Northwest, and Pacific and Northwest would become sister companies. The remaining ten percent of the stock was publicly held. However, as in the

Pub. L. No. 82-183, § 31.7(a), 65 Stat. 452 (1951). These safeguards were the forerunners of I.R.C. § 355. In addition to providing a uniform and comprehensive set of rules governing split-offs, split-ups and spin-offs, section 355 eliminated the requirement that the distribution or exchange be pursuant to a corporate reorganization, so that pre-existing subsidiaries may be spun or split off without going through the formality of transferring assets to them in order to make the transaction technically a reorganization. However, if a new subsidiary is to be formed prior to the split- or spin-off, the transfer of assets will generally qualify as a "divisive D reorganization." See note 48 *infra*.

43. I.R.C. § 355(a)(1)(A)(i). A distribution may also be made to a security holder in exchange for its securities. I.R.C. § 355(a)(1)(A)(ii).

44. "Control" is actually defined in I.R.C. § 368(c) as ownership of 80% of the combined voting power of all voting stock and of 80% of the number of shares of each nonvoting class of stock.

45. I.R.C. § 355(a)(1)(B).

46. *Id.* §§ 355(a)(1)(C), 355(b)(2)(B). See note 87 *infra*.

47. *Id.* § 368(a)(1)(D). See note 44 *supra* and text accompanying note 85 *infra*.

48. If the distribution to the shareholders had qualified as a spin-off, the transfer of assets from Pacific to Northwest would therefore constitute a "divisive D reorganization"—that is, a transfer of part of the assets of one corporation to another followed by a distribution under I.R.C. § 355 of the new corporation's stock. I.R.C. § 368(a)(1)(D). See generally Bittker & Eustice, *supra* note 39, ¶ 13.03.

Redding transaction, AT&T decided to use the transaction to raise operating capital. Accordingly, Pacific issued to its shareholders transferable rights to subscribe to Northwest stock, rather than issuing the Northwest stock directly. Prior to the transaction, the Service had issued a private letter ruling stating that the distribution was not a tax-free spin-off and that, under *Palmer*, shareholders would receive a dividend when they exercised their rights. AT&T accepted this determination,⁴⁹ but the minority shareholders contended that the transaction was a tax-free spin-off and took the Commissioner to court.

The Tax Court saw no problem with the prior use of warrants in a spin-off. The principal issue was whether a distribution by Pacific upon exercise of a warrant held by a shareholder was a "distribution with respect to its stock." The Tax Court cited *Palmer* for the proposition that the relevant "distribution" for tax purposes had not taken place until the warrants were exercised and the Northwest stock issued. Since Baan and Gordon were shareholders of Pacific,⁵⁰ and the Northwest stock could have been distributed to them outright, the court saw no reason why they should be taxed because they were required to exercise a warrant and make a payment in order to receive the distribution.⁵¹

The Commissioner's appeal in *Baan-Gordon* was to both the Second and the Ninth Circuits. The Second Circuit, in *Commissioner v. Gordon*,⁵² agreed with the Tax Court's reasoning. The Ninth Circuit, however, in *Commissioner v. Baan*⁵³ saw considerable difference between an outright distribution of stock and the use of stock warrants. Section 355 requires that stock be "distributed," and the court stated that the term "distribution" in the context of subchapter C refers to a transfer of property from a corporation to its shareholders without payment of consideration. The court acknowledged that *Palmer* had held that the sale of portfolio stock to shareholders at less than its fair market value could constitute a "distribution." However, it stated that such a deemed distribution was different from the actual distribution required to trigger section 355.⁵⁴ In addition, the court reasoned that the

49. The dividend was of no particular concern to AT&T management because it would be received tax-free under the 100% exclusion for dividends paid between members of an affiliated group provided by I.R.C. § 243.

50. 45 T.C. at 70.

51. A footnote in the opinion reveals that at some point in the case the Service had awakened to the fact that *Palmer* might no longer be good law, but the Tax Court rejected this argument without extended discussion. 45 T.C. at 91 n.7.

52. 382 F.2d 499 (2d Cir. 1967).

53. 382 F.2d 485 (9th Cir. 1967).

54. *Id.* at 492-93.

basic premise of section 355, like that of the other reorganization provisions of the Code, is that immediately after the transaction, the spun-off corporation would be owned by the shareholders who owned the original corporation, so that the transaction merely readjusted the form of the shareholders' ownership of the two corporations.⁵⁵ The use of warrants requiring payment of consideration, the court held, more closely resembled a sale than a tax-free reorganization, particularly where the warrants were transferable to non-shareholders.⁵⁶

Baan and *Gordon* converged again in the Supreme Court, which affirmed the Ninth Circuit on an alternative ground.⁵⁷ The distribution of Northwest stock warrants had actually consisted of two distributions separated by two years, and the Supreme Court held that the two distributions could not be aggregated for purposes of meeting the eighty-percent-control distribution requirement.⁵⁸ Thus, the Supreme Court held that the transaction was a taxable spin-off but did nothing to resolve the basic disagreement over the meaning of a "distribution with respect to its stock" which had split the Second and Ninth Circuits. This was the basic issue faced by the Seventh Circuit in *Redding*. Moreover, the Court's cryptic footnote raising the issue of the continued validity of *Palmer*⁵⁹ further confused the area.

Redding v. Commissioner

In *Redding*, it was originally stipulated that the three ancillary requirements of section 355 had been met. Although the Service changed its position on one of its stipulations, the principal issue remained whether the water company's distribution of Shorewood stock to the Reddings upon their exercise of previously distributed stock warrants constituted a distribution "with respect to its stock . . . solely of stock or securities."⁶⁰

The Tax Court in *Redding* stuck to its belief that the prior issuance of transferable warrants did not disqualify a spin-off under section 355.⁶¹ However, mindful of the mixed reviews its opinion in *Baan-Gordon* had received on appeal, it sought to bolster its analysis. Moreover, in light of the growing doubt as to the status of *Palmer*, the court

55. *Id.* at 495.

56. *Id.*

57. 391 U.S. 83 (1968).

58. *Id.* at 94-98. The Ninth Circuit had reached the same conclusion. See 382 F.2d at 496-98.

59. See text accompanying notes 33-34 *supra*.

60. See text accompanying notes 45-47 *supra*.

61. *Redding v. Commissioner*, 71 T.C. 597 (1979).

could not simply assume, as it had done previously, that the issuance of the warrants was a mere offer and not a taxable event. To deal with these problems, the court assumed that both the issuance of the warrants and the transfer of stock upon the exercise were “distributions of property,” and invoked the step transaction doctrine to disregard the issuance of warrants as “merely a procedural device to give Water Company shareholders the opportunity to be included or excluded from the Shorewood stock distribution by their own decision Thus, their distribution was merely a brief transitory phase of the corporate separation.”⁶² Accordingly, the court did not reach the issue of whether the issuance of the warrants would have constituted a dividend had it not been a mere procedural device.⁶³

The Tax Court’s attempt to restate its *Baan-Gordon* decision in step transaction terms dictated the shape of the Seventh Circuit’s opinion.⁶⁴ The Seventh Circuit began its analysis with the assumption that two distributions had taken place—a distribution of warrants and a subsequent distribution of stock—and proceeded to address three issues: first, whether the distribution of stock was disqualified because the earlier distribution of warrants violated the “solely stock and securities” requirement;⁶⁵ second, whether the distribution of stock was disqualified because it was made “with respect to” warrants rather than water company stock;⁶⁶ and third, whether the distribution of stock was disqualified because less than eighty percent of the stock was distributed to shareholders.⁶⁷ All three of these issues presuppose that the transfer of stock from the water company to its shareholders who exercised their warrants was a distribution for purposes of section 355. However, the rule that a distribution takes place upon the exercise of warrants is a corollary of *Palmer*, which the court decided in the second half of its opinion had been overruled.

It is true that *Palmer* has generally been interpreted as turning on the definition of “property” rather than that of “distribution.”⁶⁸ However, it is clear from the *Palmer* opinion that the Supreme Court regarded the term “distribution” as one having a specialized meaning in

62. *Id.* at 610-11.

63. *Id.* at 603 n.4.

64. *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981).

65. 630 F.2d at 1169-78. Warrants are not “stock or securities.” *Treas. Reg. § 1.355-1(a)*. See also *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 198 (1942). The “solely” issue was also mentioned by the Ninth Circuit in *Baan-Gordon*. See 382 F.2d at 492.

66. 630 F.2d at 1178-80. See text accompanying notes 80-82 *infra*.

67. 630 F.2d at 1180-81. See text accompanying notes 84-85 *infra*.

68. See, e.g., Comment, *supra* note 15, at 150.

the corporate context. The basis for the Court's conclusion that the issuance of rights did not constitute a dividend was that no "distribution of corporate assets" took place upon the issuance. Accordingly, the *Palmer* Court characterized the rights as "at most options or continuing offers," and noted that "distribution of the corporate property could take place only on their exercise."⁶⁹

The fact that *Palmer* established that only the exercise of rights could constitute a distribution does not necessarily mean that the overruling of *Palmer* implies that only the issuance of rights may constitute a distribution. It is possible that both the issuance and exercise of rights can constitute distributions, which is what the Seventh Circuit apparently assumed. However, such a conclusion would be at odds with the detailed scheme of subchapter C, the enactment of which was the ultimate basis for the conclusion that *Palmer* was obsolete. Throughout subchapter C, the term distribution is used in the context of a transfer from a corporation to its shareholders or security holders in relation to their rights as participants in the corporation's capital. Thus, the term is used to refer to 1) a transfer to the shareholder for no consideration, in which case it is a dividend to the extent of the corporation's earnings and profits;⁷⁰ 2) a transfer in consideration for the surrender of the shareholder's stock, in which case it may, under the proper circumstances, be either a redemption or a liquidation;⁷¹ and 3) an exchange for certain other stocks and securities in some of the reorganization provisions.⁷² The term is never used for a transfer from the corporation to the shareholder in exchange for the payment of consideration in cash or other property. Such transfers are treated simply as sales.

The difficulty with a sale between a corporation and its shareholders is always that the sale may contain an element of a distribution to the extent that the sale is for less than the value of the property. When the sale is made outright without the intervention of the issuance of rights, the regulations provide that, although the transfer of the property pursuant to the sale is not a distribution, the excess of the value of the property over the consideration paid is treated as a distribution.⁷³ When there is an issuance of rights, the Supreme Court's conclusion in *Palmer* that a distribution could not take place until the rights were

69. 302 U.S. at 71. See text accompanying notes 21-22 *supra*.

70. I.R.C. § 301. See generally Bittker & Eustice, *supra* note 39, ¶ 7.2.

71. I.R.C. §§ 302, 331. See generally Bittker & Eustice, *supra* note 39, ¶¶ 4.08, 11.01.

72. I.R.C. §§ 354, 356. See generally Bittker & Eustice, *supra* note 39, ¶14.01.

73. Treas. Reg. § 1.301-16. See Gann, *supra* note 15, at 937-39.

exercised led to numerous difficulties in determining the amount, the nature and timing of the distribution.⁷⁴ The abandonment of *Palmer* clears the way for determining that the distribution in such a transaction takes place at the moment the rights are issued, and any further transactions regarding the rights, whether by an exercise, sale or lapse, contain no distributive element.

The result of the failure by the Seventh Circuit to address the issue of whether the transfer of water company stock constituted a distribution is apparent if one reviews the court's reasoning with a view towards deriving general rules applicable to other types of spin-offs, utilizing nontransferable stock warrants. Under the Seventh Circuit's *Redding* analysis, the first question would be whether the step transaction doctrine could be used to disregard the initial distribution of stock warrants. The court in *Redding* reviewed separately each of the three tests which have been developed in applying the step transaction doctrine.

First, the court concluded that the issuance of stock warrants did not satisfy the "end result" test. The warrants, the court said, had not been inserted into the transaction for the purpose of furthering the end result of distribution of the Shorewood stock to water company shareholders. Rather, the warrants served the purpose of enabling the water company to raise new capital, which was a separate and "somewhat inconsistent" objective from the spin-off of Shorewood.⁷⁵ The transferability of the warrants aided this objective by permitting water company shareholders to sell their rights to persons willing to purchase the Shorewood stock.

Second, the issuance of the warrants was held to fail the "interdependence" test. While the exercise of the warrants by water company shareholders was dependent upon the warrants having been issued, the issuance of the warrants was not dependent upon their exercise by shareholders. The court noted that water company would have divested itself of Shorewood stock and raised the capital required even if all of the warrants had been sold to third parties.⁷⁶

Finally, the Seventh Circuit found that the "binding commitment" test had not been met because it was conceded that the water company

74. See *Gann*, *supra* note 15, at 937-39.

75. 630 F.2d at 1175-77. The "end result" test focuses on whether steps in a transaction were taken "in furtherance of" an overall plan. *Id.* See, e.g., *Kuper v. Commissioner*, 533 F.2d 152, 155-56 (5th Cir. 1976).

76. 630 F.2d at 1177-78. The "interdependence" test focuses on whether one step in a series would be purposeless without completion of the series. See, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

was bound to distribute the Shorewood stock not merely to shareholders, but to anyone who held a warrant.⁷⁷ Nevertheless, the Seventh Circuit made a contribution to the interpretation of the binding commitment test by declining to consider it as dispositive, despite language in the Supreme Court's *Gordon* opinion which could be read to require a binding commitment as a prerequisite to any application of the step transaction doctrine.⁷⁸

Thus, the Seventh Circuit's analysis of all three step transaction tests hinged in large part upon the transferability of the warrants, and it may be inferred that the Seventh Circuit would apply the step transaction rule to find that a spin-off employing nontransferable warrants could qualify under section 355. However, if the overruling of *Palmer* means that the exercise of the warrants do not constitute a distribution at all, the transferability of the warrants would be irrelevant.

This distinction is more than a technicality. It reflects a fundamental difference between a spin-off in the form of a direct distribution of stock, merely involving a reorganization of the ownership of the corporate group, and a spin-off in the form of a sale of the stock of the spun-off corporation to the shareholders of the original corporation, which involves a realization by the distributing corporation of a portion of the value of its assets. Although there may be a distributive element in the latter transaction, what is "distributed" is not ownership of the spun-off corporation, but the excess of the value of the spun-off corporation over the amount which is realized by the distributing corporation. The implication is that spin-offs which involve the use of warrants requiring the payment of consideration for the receipt of the spun-off corporation's stock, whether such warrants are transferable or not, cannot qualify under section 355 because the fundamental element of a distribution of stock is missing.

Although what is "distributed" in a spin-off utilizing warrants is technically the excess in value of the spun-off corporation's stock over the exercise price, rather than the stock itself, the result of the transaction is that shareholders of the distributing corporation wind up directly owning both the distributing corporation and the spun-off corporation, subject to the possibility that they may have sold their

77. 630 F.2d at 1178.

78. *Id.* As discussed previously, there were two separate distributions of warrants in *Baan-Gordon*, and the Supreme Court held that the two could not be aggregated because at the time of the first distribution there was no "binding commitment" to make the second distribution. 391 U.S. at 96. The Seventh Circuit interpreted the binding commitment test as applying primarily to situations in which the "steps" occur in separate taxable years. 630 F.2d at 1178.

rights to receive the spun-off corporation's stock. A court inclined to take this view could apply the Tax Court's step transaction theory in reverse, holding that the transfer of stock should be treated as a part of the initial distribution. Such an approach, however, would put a considerable strain on the language of section 355.⁷⁹

Nevertheless, assuming that some version of the step transaction theory can be used to satisfy the distribution of stock requirement, there remain the Seventh Circuit's two alternative grounds for decision in *Redding*. First, the court held that the Shorewood stock had not been distributed "with respect to" the water company stock, as required by section 355(a)(1)(A), because the stock had been distributed to anyone who held a warrant, whether they were water company shareholders or third party purchasers.⁸⁰ This conclusion rests on a somewhat strained reading of the statute. The operative language of section 355 provides that no gain or loss shall be recognized by a shareholder who receives a distribution with respect to *his* stock, providing that the other requirements of the section are met. The Reddings clearly were water company shareholders who received Shorewood stock with respect to their water company stock holdings. The Seventh Circuit essentially concluded that because water company shareholders were given the opportunity to transfer their warrants, and some shareholders other than the Reddings did so, the distribution of Shorewood stock to the Reddings was not with respect to their stock. This reading seems contrary to the focus of section 355 which is on the individual shareholder who receives the stock.

It is, of course, common in corporate reorganizations that an individual shareholder may receive nothing in the course of the reorganization other than stock in other corporations involved in the reorganization, but that the transaction viewed as a whole may constitute a sale, so that all shareholders are denied nonrecognition treatment. To deal with this situation, courts developed the "continuity of interest" doctrine, which generally provides that no transaction will be treated as a tax-free reorganization unless shareholders in the original corporations involved in the transaction wind up owning a substantial equity interest in the resulting corporations.⁸¹

79. The Supreme Court, in *Gordon*, stated that "the requirements of [I.R.C. § 355] are detailed and specific, and must be applied with precision." 391 U.S. at 91-92. Thus, any attempt to stretch I.R.C. § 355 to apply to transactions within its spirit but not its letter is of dubious validity. See note 87 *infra*.

80. 630 F.2d at 1178-80.

81. Treas. Reg. § 1.368-1(b). The 50% test is a rule of thumb based on the Service ruling standards. Rev. Proc. 77-37, 1977-2 C.B. 568. The legislative history of I.R.C. § 355 indicates that

The Tax Court in *Redding* attempted to apply this theory, by holding that the distribution of Shorewood stock had been with respect to the water company stock because water company shareholders ended up owning more than fifty percent of the Shorewood stock.⁸² The Seventh Circuit, however, rejected this argument, stating merely: "We know of no authority that mere satisfaction of the 50 percent standard is enough to meet the section 355(a)(1)(A) problem."⁸³ It is not surprising that the court knew of no such authority as it had essentially created the "section 355(a)(1)(A) problem" by its conclusion that the determination of whether a distribution to a shareholder was "with respect to his stock" turns upon whether other shareholders had sold their rights to receive the stock.

The court's conclusion was that the Shorewood transaction failed to satisfy the distribution of control requirement of section 355(a)(1)(D) because even though the water company divested itself of eighty percent of the Shorewood stock, not all of it was distributed to water company shareholders.⁸⁴ Once again, the Seventh Circuit's conclusion appears to be based on a somewhat strained reading of the statute. Section 355(a)(1)(D) only requires that eighty percent of the distributing corporation's stock be distributed, not that it be distributed "to shareholders." Moreover, the actual terms of the section 355(a)(1)(D) require that the distributing corporation must either distribute all of its stock and securities, or must both distribute an amount constituting control of the spun-off corporation and demonstrate to the satisfaction of the Service that its retention of the remaining stock and securities is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. It would thus seem clear that the fo-

Congress intended that the objective tests set forth therein would supplant the need for such judicial doctrines. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 236-37 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4253-54.

82. The Tax Court's discussion of the "in respect to" issue is not entirely clear. At one point, it cited Rev. Rul. 68-21, 1968-1 C.B. 104, for the proposition that the distribution upon exercise by a shareholder of his warrant is with respect to his stock regardless of how many other shareholders sell their warrants. 71 T.C. at 611. However, it seemed to qualify this statement by noting that since continuity of interest existed, there was no abuse of I.R.C. § 355. *Id.* at 610-11. The Seventh Circuit interpreted this to mean that a spin-off employing warrants might not be considered "in respect to" stock if a majority of the shareholders sold their warrants, breaking the continuity of interest.

83. 630 F.2d at 1180.

84. *Id.* The water company distributed almost 80% of its Shorewood stock, but 50,000 shares went to underwriters rather than shareholders, and an additional unknown number went to purchasers of warrants. The Service had originally stipulated that I.R.C. § 355(a)(1)(D) was satisfied. However, the Tax Court treated the question of whether I.R.C. § 355(a)(1)(D) required distributions to shareholders as a pure issue of law which could be raised on brief notwithstanding the stipulation. 71 T.C. at 605.

cus of section 355(a)(1)(D) is upon requiring the distributing corporation to completely divest itself of stock and securities in the spun-off corporation, rather than upon the recipients of the stock and securities.⁸⁵

As in its analysis of the step transaction issue, the court's conclusions on the latter two issues would appear to permit the use of non-transferable warrants in a spin-off transaction. Transferable warrants, on the other hand, would seem to be effectively precluded by the Seventh Circuit's approach, since if even a single shareholder transferred his warrant, the "with respect to" requirement would be violated, and, moreover, it would then be necessary for the distributing corporation to demonstrate that it had succeeded in distributing eighty percent control of the spun-off corporation to shareholders. These conclusions are objectionable on two grounds. On the one hand, the court's analysis on both points was based upon the fundamental assumption that the transfer of stock on exercise of the warrant was a distribution. It thus perpetuates the same basic error in the court's reasoning which characterized its approach to the step transaction issue and which may mislead taxpayers into believing that nontransferable warrants may be used in spin-off transactions. On the other hand, if, as discussed above, the distribution problem can be overcome, then the court's conclusion that the use of transferable warrants is always completely proscribed appears to be overly restrictive. The court seems to have assumed that it was necessary for it to give a restrictive reading to sections 355(a)(1)(A) and 355(a)(1)(D) in order to prevent abuses of the spin-off provisions. However, section 355 already contains adequate safeguards against such abuses which do not require such a strained reading of the statutory language.

It is well-established that the principal danger in spin-off transactions is that a corporation may transfer a portion of its accumulated earnings to a subsidiary and spin the subsidiary off to its shareholders, allowing them, through sale or redemption of their stock in the subsidiary, to recognize income as capital gain which should be taxed as dividends.⁸⁶ To prevent such transactions, section 355(a)(1)(B) specifically provides that a spin-off will not be eligible for tax-free treatment if it is

85. There is no explicit explanation for the requirements of section 355(a)(1)(D) in the legislative history of I.R.C. § 355. It may be based on a provision in the regulations under § 112(b)(11) of the 1939 Code, which provided that bona fide business reasons for a spin-off would ordinarily require that all of the stock be distributed in order to effect a complete corporate separation. Partial distributions were considered more likely to be for the purpose of distributing earnings. Treas. Reg. § 39.112(b)(11)-2(c). See note 42 *supra*.

86. See note 42 *supra*.

used principally as a device for the distribution of earnings of one of the corporations involved. Moreover, section 355(a)(1)(C) requires that the spun-off subsidiary be engaged in a separate trade or business which has been actively conducted for at least five years. This requirement parallels the separate business requirement in the partial liquidation area, so that a corporation cannot indirectly accomplish through a spin-off what it cannot directly accomplish through a partial liquidation.⁸⁷ In *Redding*, it was stipulated that both sections 355(a)(1)(B) and 355(a)(1)(C) were satisfied. It would appear, therefore, that the underlying purposes of section 355 were not violated by the transaction, and that there was no need for the Seventh Circuit to warp the meaning of sections 355(a)(1)(A) and 355(a)(1)(D) in order to guard against a non-existent abuse.⁸⁸

In summary, the results of *Redding* can only be described as mixed. By abandoning *Palmer*, the Seventh Circuit has paved the way for a more rational and consistent treatment of distribution of rights to acquire corporate property. However, the court failed to follow through on its conclusion concerning *Palmer* in construing section 355. As a result, its approach to the use of warrants in spin-offs appears to be somewhere between the liberal substance over form approach of the

87. Under I.R.C. § 331(a)(2), a distribution in partial liquidation of a corporation may produce a capital gain. I.R.C. § 346(b) provides a safe harbor definition for partial liquidation if the liquidation is due to the corporation's ceasing to conduct a trade or business which has been actively conducted for five years, and if the corporation continues after the distribution to conduct another active trade or business which it has conducted for five years. The same basic two-business five-year rule is applied under I.R.C. § 355(a)(1)(C). See I.R.C. § 355(b). Thus, in most cases assets which could be spun off in order to bail out corporate earnings in a transaction such as that involved in *Gregory v. Helvering*, 293 U.S. 465 (1935), see note 42 *supra*, could be distributed directly in a partial liquidation. For a full discussion of the intricacies of I.R.C. § 355(a)(1)(C), see *Bittker & Eustice, supra* note 39, ¶¶ 13.04, 13.05.

88. See note 81 *supra* for indications in the legislative history that Congress intended the provisions of I.R.C. § 355 to be adequate safeguards against abuse of spin-offs. I.R.C. § 355(a)(1)(B) specifically provides that sales of spun-off stock by shareholders following the transaction shall not be considered evidence that the spin-off is a device for distribution of earnings, unless such sales are negotiated or agreed upon prior to the distribution. The Seventh Circuit noted in a footnote that a sale of a shareholder's warrant could be considered a sale of his stock arranged prior to the distribution. 630 F.2d at 1180 n.22. Moreover, the court stated that any such sale might cause a distribution to be presumed to be a "device," and seemed to indicate that the sale of 50% or more of the warrants would be conclusive. *Id.* This theory provides a further obstacle to the use of transferrable warrants in a spin-off.

The distinction between transferable and nontransferable warrants may be one more of substance than form, however, at least in the case of publicly traded corporations. In such a corporation, there will always be an interval between the time a distribution of portfolio stock is announced and the time it occurs, and in that interval, if demand is sufficient, the stock to be distributed will trade on a when-issued basis. The Seventh Circuit declined to express an opinion as to whether when-issued trading was the equivalent of the use of transferable warrants, 630 F.2d at 1176 n.16, but the Service has already indicated that it considers them equivalent. Rev. Rul. 80-292, 1980-2 C.B. 104.

Tax Court and the Second Circuit in *Baan*, and the strict constructionist approach of the Ninth Circuit in *Gordon*. Corporations seeking an answer as to the outer limits of the permissible use of such warrants will find little useful guidance in *Redding*.

DEDUCTIBILITY OF JOINT VENTURE START-UP EXPENSES

*Madison Gas & Electric Co. v. Commissioner*⁸⁹ provides an interesting example of the way in which litigation strategies can effect the development of the tax laws. The issue in *Madison Gas* was whether certain expenditures incurred in connection with the formation of a joint venture constituted deductible business expenses or had to be capitalized. The Service elected to stipulate the factual issue in the case, which it might very well have won, in the hopes of obtaining a *per se* rule of law which could be applied in other partnership cases, and its strategy paid off.⁹⁰ The taxpayer, on the other hand, apparently decided for tactical reasons not to raise an argument which could have provided it with an escape hatch from the capitalization requirement. As a result, *Madison Gas* is an incomplete case: it gives notice to taxpayers contemplating expanding their business through a joint venture that certain expenses incurred may be nondeductible even though they would have been deductible had the taxpayer incurred them individually, but it does not resolve the question of whether it is possible to avoid this result.

Madison Gas is a public utility operating in Wisconsin, engaged in the generation and distribution of electricity and in the purchase and distribution of natural gas. In order to meet a growing demand for electricity, Madison Gas decided to enter into a joint venture with two other Wisconsin utilities to construct and operate a nuclear power generating plant. Under the terms of the agreement the three utilities were to own the plant as tenants in common, would be responsible for all expenses of the plant and would be entitled to use the output of the plant, all in proportion to their "Ownership Share." Prior to the time the plant began operation, the three utilities incurred expenses for the training and relocating of the personnel to be used to operate the

89. 633 F.2d 512 (7th Cir. 1980), *aff'g* 72 T.C. 521 (1979).

90. *Madison Gas* is already being cited as standing for the proposition that a partnership's start-up expenses are nondeductible. See *In re Boyd*, 76 T.C. 646 (1981); *Goodwin v. Commissioner*, 75 T.C. 424 (1980). In cases involving tax shelters, which are usually organized as limited partnerships with disproportionately large expenses in early years, the *Madison Gas* holding will be useful to the Service.

plant.⁹¹ Madison Gas deducted its share of these expenditures as "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business" under section 162, and the Service, citing *Richmond Television Corp. v. United States*,⁹² disallowed the deduction.

In *Richmond Television*, a corporation formed for the purpose of operating a television station incurred training and personnel expenses prior to the time it was granted a license and authorized to begin broadcasting. Although personnel expenses are ordinarily deductible, the Fourth Circuit held that such expenses were incurred in acquiring a trade or business rather than in carrying one on, and were therefore capital expenditures under section 263.

The Service in *Madison Gas* stipulated that the expenses involved would have been deductible notwithstanding *Richmond Television* had Madison Gas constructed the nuclear power plant itself, because they were incurred in the course of Madison Gas' ongoing business of selling electricity. This stipulation represents a surprisingly narrow interpretation of *Richmond Television* for the Service, and it is questionable whether the Service would take the same position in a case which did not involve a partnership.⁹³

In *Madison Gas* itself, the stipulation served its purpose of focusing the court's attention on the Service's main argument that the expenditures were capital because they had been made by a partnership, and the partnership had not yet begun carrying on a trade or business. Thus, the issues in the case became whether the joint venture was a partnership for tax purposes and, if so, whether it was the business of the partnership or that of the individual partners which was relevant in

91. The expenses included fees for various training and orientation courses, salaries and reimbursed travel expenses for the personnel undergoing training; gas, oil and maintenance expenses for vehicles used in the training; preparation of manuals, outlines and similar materials; and related overhead costs. 72 T.C. at 541-42.

92. 345 F.2d 901 (4th Cir.), vacated and remanded on other grounds, 382 U.S. 68 (1965), on remand, 354 F.2d 410 (4th Cir. 1965).

93. The Service's stipulation was purportedly based upon the theory that *Richmond Television* applies only to expenses incurred in connection with a new business. See 72 T.C. at 557-58. However, in *NCNB Corp. v. United States*, 651 F.2d 942 (4th Cir. 1981), the Fourth Circuit itself rejected this reading of *Richmond Television* in holding that expenditures incurred by a bank in planning the opening of new branches were capital. The test, the court said, is not whether the expenditure is incurred in a new business or an old business, but whether it is incurred in order to produce future income, so that a proper matching of revenues and expenditures requires that it be capitalized and amortized. *Id.* at 955-56. However, the Service has issued two letter rulings which appear inconsistent with *NCNB*: Private Letter Rulings 8135031 (May 29, 1981) & 8141033 (June 30, 1981). Also, the Fourth Circuit has granted rehearing *en banc* on *NCNB*, so it would appear that the question of whether there is an "old business" exception to *Richmond Television* is still open. In *Madison Gas*, the Tax Court expressed reservations about the stipulation, but accepted it for purposes of the case, 72 T.C. at 558, as did the Seventh Circuit. 633 F.2d at 514 n.1.

determining whether the personnel training and relocation costs should be expensed or capitalized.

Madison Gas' argument that its joint venture was not a partnership for tax purposes was quickly and correctly disposed of by the Seventh Circuit. A partnership for tax purposes is not limited to an entity which is a partnership under state law, but includes any "syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on."⁹⁴ Despite the apparent breadth of this definition, the regulations provide that the mere co-ownership of property does not constitute a partnership, although co-owners may be considered to be partners if they "actively carry on trade, business, financial operation, or venture and divide the profits thereof."⁹⁵ Madison Gas' contention was that since the joint venture did not market electricity and distribute the profits, but merely distributed the electricity itself, it was not engaged in carrying on a trade, business, financial operation or venture within the meaning of the regulations.⁹⁶

This argument, however, foundered on the strength of *Bentex Oil Corp. v. Commissioner*.⁹⁷ There, the Tax Court had held that under the definition of a partnership contained in the 1939 Code,⁹⁸ an organization formed to extract oil and distribute the oil in kind for sale by its members was a partnership. The 1939 Code definition of a partnership was incorporated without change in the 1954 Code.⁹⁹ Congress also provided in section 761(a) for the issuance of regulations allowing a partnership to elect not to be treated as a partnership for purposes of subchapter K of the Code if, *inter alia*, "it is availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted."¹⁰⁰ The Seventh

94. I.R.C. § 7701(a)(2). The same language is found in I.R.C. § 761(a), which defines "partnership" for purposes of subchapter K of the Code.

95. Treas. Reg. §§ 1.761-1(a), 301.7701-3(a).

96. Madison Gas also argued that its joint venture was a "mere undertaking to share expenses," which is also considered not to be a partnership under the regulations. *Id.* However, the example of such an undertaking given in the regulations is that of adjoining property owners who share the expense of a drainage ditch, and the Seventh Circuit felt that the operation of a nuclear power plant involved a higher level of business activity than the digging of a ditch. 633 F.2d at 517 n.5.

97. 20 T.C. 565 (1953).

98. Int. Rev. Code of 1939, ch. 1, § 3797(a)(2), 53 Stat. 469 (repealed 1954).

99. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 353 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4025, 4378; S. Rep. No. 1622, 83d Cong., 2d Sess. 428-29 (1954), reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 5049-50. The committee reports, however, do not explicitly refer to *Bentex*.

100. This election is discussed in the text at note 116 *infra*.

Circuit confirmed the general opinion of the commentators by holding explicitly that section 761(a) had in essence codified the Tax Court's ruling in *Bentex* that such an organization was a partnership, while allowing *Bentex*-type organizations to elect out of the more burdensome partnership reporting and accounting requirements.¹⁰¹ The fact that the organization distributed its profits in kind rather than engaging in sales activities, the court said, was irrelevant.¹⁰²

Having thus concluded that the joint venture was a partnership for tax purposes, the Seventh Circuit then turned to the question of whether it was the partnership's prior business or that of Madison Gas which should be looked to in determining whether the personnel training and relocation costs should be expensed or capitalized. On this point, the court's opinion is regrettably cryptic. The court characterized the issue as whether the partnership should be disregarded as lacking economic substance, and seemed to imply that, unless the partnership lacked economic substance, it would be compelled to hold that the expenditures were nondeductible under section 263.¹⁰³ However, there is nothing in section 263 which specifically provides that partnership start-up expenses are always capital items. Section 263 merely provides that capital expenditures are not deductible. It has generally been left to the Service and the courts to determine on a case-by-case basis what expenditures are properly charged to the capital account.¹⁰⁴ There would have been nothing to preclude the Seventh Circuit from concluding that a partner's share of the start-up expenses of a partnership should be considered deductible expenses if the formation of the part-

101. 633 F.2d at 515-16. See, e.g., Taubman, *Oil and Gas Partnerships and Section 761(a)*, 12 TAX. L. REV. 49, 67 (1956).

102. The Seventh Circuit's reasoning went somewhat beyond the Service's argument, and may have unintended consequences. The Service's general position is that a distribution in kind of produced or extracted materials is not a division of profits. It has followed this position in holding that unincorporated organizations which distribute products in kind cannot be associations taxable as corporations under I.R.C. § 7701(a)(2) because they lack a profit motive, even if they possess the four "corporate characteristics" of centralized management, continuity of life, free transferability of interests and limited liability. Treas. Reg. § 301.7701-2(a). See I.T. 3948, 1949-1 C.B. 161; I.T. 3930, 1948-2 C.B. 126; Private Letter Ruling 7826096 (March 31, 1978). In the partnership context, the Service's position is that a joint profit motive is merely one characteristic of a partnership, and that the lack of such a motive may be compensated for by a sufficient level of business activity. This is the argument the Service actually made in *Madison Gas*. See 633 F.2d at 516 n.3. It remains to be seen whether the Seventh Circuit's holding that a distribution in kind constitutes a profit sharing relationship will affect the Service's position on the tax classification of unincorporated associations. *Contra*, Allison v. Commissioner, 45 T.C.M. (CCH) 1055 (1976).

103. 633 F.2d at 517.

104. See Bittker & Eustice, *supra* note 39, ¶ 5.04. There are, however, a number of situations in which the Code provides specific rules regarding the capitalization or deductibility of expenses. Several of these are contained in paragraphs (b) through (g) of I.R.C. § 263 itself. See also I.R.C. §§ 174, 175, 177, 178, 266, 278.

nership is essentially an extension of the partner's preexisting trade or business.¹⁰⁵

There is one statement in the Seventh Circuit's opinion which can be construed as a policy justification for its conclusion that partnership start-up expenses are always capital, regardless of the partner's trade or business. Madison Gas cited in support of its position a series of cases which have held that the costs incurred by banks in setting up or joining associations which act as clearing houses for bank credit card systems were deductible as business expenses.¹⁰⁶ The court noted that in those cases the bank's participation in the credit card system had not created any separate assets or property interest.¹⁰⁷ It is not clear, however, what "asset" the Seventh Circuit felt was created by Madison Gas' share of start-up expenses. The asset cannot have been Madison Gas' ownership interest in the nuclear plant itself, since if that were the case, the expenses would not have been deductible even if incurred by Madison Gas individually, contrary to the Service's stipulation. If the Seventh Circuit meant that the asset created was the going concern value of the joint venture's activity, its reasoning was circular in that the basic issue raised was whether the joint venture's activity was a separate trade or business or a mere continuation of the business of the three utilities.¹⁰⁸ Accordingly, the Seventh Circuit's statement makes sense only if the asset to which it referred was Madison Gas' partnership interest in the partnership created by the joint venture agreement.¹⁰⁹ This conclusion highlights the main issue that was raised, but not resolved, by the case.

105. See note 118 *infra*.

106. First Nat'l Bank of South Carolina v. United States, 558 F.2d 721 (4th Cir. 1977); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974); First Sec. Bank of Idaho v. Commissioner, 63 T.C. 644 (1975).

107. 633 F.2d at 517. The court also noted that no suggestion was made in the credit card cases that the organizations administering the credit card clearing systems constituted partnerships under I.R.C. § 7701(a)(3). However, the conclusion reached in the credit card cases has been questioned. See NCNB v. United States, 651 F.2d 942 (4th Cir. 1981). See also note 93 *supra*. The question of whether an expenditure *must* create or enhance an asset of some kind in order to be capitalized was raised by dicta in Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971), and has divided the circuits. Compare NCNB v. United States, 651 F.2d 942 (4th Cir. 1981), with Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973).

108. Going concern value is an intangible asset reflecting the increased value of a business' assets caused by the fact that they are organized as an operating enterprise. It is similar to, but distinct from, goodwill. Of course, the expenditures could be considered to have enhanced Madison Gas' own going concern value but this again would contradict the stipulation that the expenditures would have been deductible if incurred directly.

109. This conclusion in itself raises a problem, in that, as discussed at notes 116-17 *infra*, the joint venture had elected not to be subject to subchapter K, and therefore the provisions of subchapter K providing for a partnership interest to be a separate asset with a distinct basis were not applicable. See note 115 *infra*.

As discussed above, section 761(a) allows an unincorporated association, such as the joint venture involved in *Madison Gas*, to elect not to be treated as a partnership for purposes of subchapter K of the Code. In fact, the joint venture had made this election, but *Madison Gas* did not raise the argument that the making of the election should exempt the joint venture's start-up expenditures from the *Richmond Television* rule, apparently because it was afraid that the making of the election would be construed as an admission that the joint venture was a partnership. If this was its reasoning, the tactic backfired. The Service made the contention that the making of the election constituted an admission anyway, and the Tax Court rejected it.¹¹⁰ The Tax Court, however, went on to note that it might have been receptive to an argument that the section 761(a) election should cause the expenditures to be deductible had *Madison Gas* chosen to make the argument.¹¹¹ *Madison Gas* then belatedly sought to raise the issue on appeal. The Seventh Circuit declined to consider the question because it had not been raised in the Tax Court, but noted in a footnote that it was questionable whether a section 761(a) election should affect the deductibility of the expenses, in that the election applies only to subchapter K.¹¹² Section 263, which precludes the deduction of capital expenditures, is contained in subchapter B.

It is unfortunate that *Madison Gas* chose not to raise this argument, and doubly unfortunate that the Seventh Circuit chose to comment on the issue without examining it carefully. If the Seventh Circuit's footnote is an indication that the court's inclination is to rule that a section 761(a) election is irrelevant to the *Richmond Television* issue, it is wrong.

The mere fact that section 263 is not included in subchapter K does not mean that a section 761(a) election is irrelevant to the deductibility of a partnership's start-up expenses. As discussed above, section 263 merely states the general rule that capital expenditures are not deductible; it does not specify that a partnership's start-up expenses must always be considered capital expenditures. That issue is left for the Service and courts to resolve on a case-by-case basis. Notwithstanding the above criticism of the Seventh Circuit's cursory treatment of the question of whose trade or business is relevant for determining the applicability of *Richmond Television* to a partnership's start-up expenses,

110. 72 T.C. at 558.

111. *Id.* at 559 n.9.

112. 633 F.2d at 515 n.2.

there are a number of policy reasons for treating a newly formed partnership as always being engaged in a new trade or business regardless of the trade or business of its partners. However, these policy reasons are applicable only if the partnership is treated as a partnership for purposes of subchapter K.

Although a partnership pays no taxes and its income and expenses flow through directly to its partners,¹¹³ it is generally treated as a separate entity under subchapter K. Generally, it is to the partnership, and not to the individual partners, that the tax law looks to determine the nature of the business in which items of partnership income and expense are earned or incurred.¹¹⁴ Moreover, a partnership interest is considered a separate asset from a partner's ownership share in the partnership's individual assets, so that a partner who sells his partnership interest is generally treated as selling a single asset rather than an undivided interest in all of the partnership's properties.¹¹⁵

In these circumstances, it makes sense to treat a partnership as being engaged in a separate trade or business which is subject to the *Richmond Television* rule requiring the capitalization of start-up expenses. However, when a partnership is permitted to elect out of subchapter K under section 761(a), the partnership is generally disregarded as a separate entity, and each partner is treated as individually owning his share of the partnership's assets. However, the availability of the section 761(a) election is limited. As discussed above, one of the types of partnerships which is eligible for the election is the type that was formed by *Madison Gas*: one which is engaged merely in the production of property but not in the complete business activity of producing and marketing it.¹¹⁶ Moreover, section 761(a) specifies that the election is available only if the income of the partners "may be adequately deter-

113. I.R.C. §§ 701, 702.

114. Thus, if the partnership is engaged in a trade or business, its expenses and losses are deductible by the partners as though they were engaged in the trade or business, even though they may be mere passive investors in the partnership. See Treas. Reg. § 1.702-1(b). The Tax Court discussed this issue in more detail in *Goodwin v. Commissioner*, 75 T.C. 424 (1981), in which it declined to contravene *Madison Gas*. For a complete discussion of the difference between the "aggregate" and "entity" theories of partnership taxation, see I. W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.02 (1977).

115. I.R.C. § 741. However, I.R.C. § 751 contains special rules designed to prevent the conversion of ordinary income into capital gain through the sale of a partnership interest, analogous in purpose though not in operation to the collapsible corporation rules of I.R.C. § 341.

116. I.R.C. § 761(a)(2). See note 100 *supra*. The other class of partnership eligible for a I.R.C. § 761(a) election are those formed solely for investment. I.R.C. § 761(a)(1). In 1978, temporary organizations of securities dealers formed for underwriting purposes were added as I.R.C. § 761(a)(3), but as yet no regulations extending the election to such arrangements have been promulgated.

mined without the computation of partnership taxable income." Thus, the basic premise of the section 761(a) election is that the partners should not be considered as having formed a separate business entity, but merely as having entered into a cooperative arrangement in the furtherance of their own individual businesses. In such circumstances, the argument of *Madison Gas* that its participation in the joint venture should have been considered merely as an extension of its own trade or business is highly compelling, although it is possible that even if the partnership had been disregarded, the type of expenditures involved in *Madison Gas* might have been considered capital but for the Service's stipulation.¹¹⁷

A further argument in favor of not applying *Richmond Television* to start-up expenditures of a partnership which has been permitted to elect out of subchapter K is found in section 709, which permits a partnership to amortize its organizational expenditures over not less than sixty months.¹¹⁸ The deductibility of organizational expenditures as defined in section 709 was not in issue in *Madison Gas*, but the formation of a joint venture such as that involved in the case would require organizational expenses. Section 709 is contained in subchapter K and accordingly would not be available to a partnership which had elected out of subchapter K under section 761(a).¹¹⁹ Thus, if the Seventh Circuit, as implied by the footnote in *Madison Gas*, would hold that section 761(a) has no effect on the deductibility of a partnership's start-up expenses, presumably including organizational expenses, the result would be that a partnership which is engaged in a separate business and therefore ineligible to elect under section 761(a) could amortize its

117. See note 93 *supra*.

118. I.R.C. § 709(a) provides that organization and syndication expenses are not deductible, and I.R.C. § 709(b) provides for the amortization of organization, but not syndication, expenses. The purposes of I.R.C. § 709 were to eliminate any implication in I.R.C. § 707(c) that guaranteed payments made to managing partners for organizing the partnership and selling partnership interests were currently deductible even though the partnership had not yet begun to do business, and to provide a five-year amortization election for organizational expenses similar to that available for corporations under I.R.C. § 248. The regulations under I.R.C. § 248, and those proposed under I.R.C. § 709, require that the expenses amortized be those connected with forming the corporation or partnership itself rather than starting its business. Treas. Reg. § 1.248-1(b)(2); Prop. Treas. Reg. § 1.709-2(a), 45 Fed. Reg. 2349 (1980). This problem was resolved in the Miscellaneous Revenue Act of 1980 by the enactment of Code section 195, which provides a general five-year amortization schedule for all start-up expenses incurred after July 29, 1980. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102, 94 Stat. 3522 (1980). See H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980); S. Rep. No. 1036, 96th Cong., 2d Sess. 10 (1980), reprinted in [1980] U.S. CODE CONG. & AD. NEWS 7300.

119. I.R.C. § 761(a) does provide for a partnership to elect out of part but not all of subchapter K, and presumably a partnership could request to be excluded from all subchapter K provisions except for I.R.C. § 709. See Treas. Reg. § 1.761-2(c). Whether the Service would honor such a request is questionable.

organizational expenses, whereas a partnership eligible for a section 761(a) election could neither deduct nor amortize its expenses. This result seems contrary to Congress' intent in enacting section 709.

The Seventh Circuit's conclusion that the start-up expenditures of a new partnership must be capitalized is a sensible one in the context of a partnership subject to subchapter K. However, it is unfortunate that the case in which the issue was raised involved a partnership which was eligible to elect out of subchapter K. The result will be to unfairly penalize existing businesses which wish to expand their operations, but can only reasonably do so by entering into cooperative ventures with other taxpayers in the same business. It is to be hoped that if in the future another case arises involving the start-up expenditures of a joint venture such as that entered into by Madison Gas, the courts will disregard the Seventh Circuit's ill-conceived dictum and address the substantive issue of whether such expenditures are ordinary and necessary business expenses under *Richmond Television*.

A LIBERALIZED RULE FOR INDIVIDUAL RETIREMENT ACCOUNT ELIGIBILITY

In *Foulkes v. Commissioner*,¹²⁰ the Seventh Circuit departed from the rule of strict construction which the Service and the courts have uniformly followed in resolving cases involving contributions to individual retirement accounts ("IRA").¹²¹ A sensible result was reached in *Foulkes* which is probably in accordance with Congress' purpose in creating IRAs; in fact, the Economic Recovery Tax Act of 1981¹²² eliminated the *Foulkes* issue entirely. However, the 1981 amendments will be applied on a prospective basis only, and taxpayers who have already fallen afoul of the complexities of the IRA provisions will have to look to *Foulkes* for relief. Unfortunately, the extent of the relief afforded by *Foulkes* is far from clear.

IRAs were created by the Employee Retirement Income Security Act of 1974 ("ERISA").¹²³ Their purpose is to extend the tax benefits enjoyed by employees whose employers maintain retirement plans for their benefit to employees whose employers are not so generous by al-

120. 638 F.2d 1105 (7th Cir. 1981).

121. IRA's are defined by I.R.C. § 408(a).

122. Pub. L. No. 97-34, § 311, 95 Stat. 277 (1981), reprinted in [1981] U.S. CODE CONG. & AD. NEWS 105 (Supp. 6).

123. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at I.R.C. §§ 401-415 & 29 U.S.C. §§ 1001-1381 (1976 & Supp. III 1979)).

lowing the latter employees to deduct contributions made to an IRA.¹²⁴ Notwithstanding their benevolent purpose, the IRA provisions have produced a volume of litigation wholly disproportionate to the amounts of revenue involved. The center of the controversy is section 219(b)(2)(A), which provides that a taxpayer may not deduct contributions made to an IRA in any year in which "for any part of such year . . . he was an active participant" in a tax-qualified retirement plan.¹²⁵ This provision was necessary to implement Congress' intent to make the benefits of IRAs available only to employees whose employers do not maintain a retirement plan for their benefit. However, the term "active participant" is not defined in section 219 and, as quickly becomes apparent upon an examination of the many cases involving the issue,¹²⁶ the term is misunderstood by a substantial number of taxpayers.

The tone of the cases dealing with this issue was set by the Tax Court in *Orzechowski v. Commissioner*.¹²⁷ Orzechowski was a participant in his employer's qualified pension plan in 1975, but, anticipating

124. Contributions made by an employer on behalf of an employee to a retirement plan qualified under section 401(a) are deductible when made even though not includible in the employee's income until distributed. I.R.C. §§ 402(a)(1), 404(a). The IRA provisions provide a comparable tax benefit (i.e., retirement savings out of pre-tax income) by allowing a deduction for contributions to an IRA equal to the lesser of 15% of compensation or \$1,500 (\$1,750 for a taxpayer with a nonworking spouse). I.R.C. §§ 219, 220. Beginning in 1982, the deduction is increased to the lesser of 100% of compensation or \$2,000 (\$2,250 for a taxpayer with a nonworking spouse). ERTA, Pub. L. No. 97-34, § 311(a), 95 Stat. 277 (1981), *reprinted in* [1981] U.S. CODE CONG. & AD. NEWS 105 (Supp. 6), *amending* I.R.C. § 219.

There are two other tax advantages to qualified retirement plans and IRAs. First, the beneficiaries are exempt from tax on income earned by the balance in the plan or in the IRA. I.R.C. §§ 408(e), 501(a). Second, distributions in the form of annuities are entitled to special treatment under I.R.C. § 72, and are excluded from the employee's estate at death under I.R.C. §§ 2039(c), (e). However, distributions from IRAs are not as favorably treated as distributions from qualified plans. There is a 10% penalty tax on distributions from an IRA before age 59½, I.R.C. § 408(f), and lump sum distributions from an IRA are not eligible for the special 10-year averaging treatment provided by I.R.C. § 402(e). There are other miscellaneous restrictions on the maintenance of IRAs contained in I.R.C. § 408 which do not apply to qualified plans.

125. The prohibition applies to active participants in a plan maintained by the taxpayer's employer which is qualified under I.R.C. § 401(a), an annuity plan under I.R.C. § 403(a), a bond purchase plan under I.R.C. § 405(a) or a governmental retirement plan. The parallel provision for married employees with nonworking spouses is contained in I.R.C. § 220(b)(3)(A) (repealed 1981). In general, the provisions of I.R.C. § 220 duplicate those of I.R.C. § 219, and will not be referred to separately. Thus, any reference in the text to the active participation requirement should be read as applying to both I.R.C. § 219(b)(2)(A) and I.R.C. § 220(b)(3)(A). Effective January 1, 1982, the provisions dealing with married participants with nonworking spouses were incorporated into I.R.C. § 219, and I.R.C. § 220 was repealed. ERTA, Pub. L. No. 97-34, § 311(c), 95 Stat. 283 (1981), *reprinted in* [1981] U.S. CODE CONG. & AD. NEWS 111 (Supp. 6).

126. There have been more than 40 Tax Court cases dealing with the active participant issue. *See, e.g.,* Johnson v. Commissioner, 37 T.C.M. (CCH) 1763 (1978), *aff'd*, 620 F.2d 153 (7th Cir. 1980); Pervier v. Commissioner, 37 T.C.M. (CCH) 1706 (1978); Orzechowski v. Commissioner, 69 T.C. 750 (1978), *aff'd*, 592 F.2d 677 (2d Cir. 1979).

127. 69 T.C. 750 (1978), *aff'd*, 592 F.2d 677 (2d Cir. 1979). The other basic case setting forth

being laid off and believing that he would obtain more benefit from an IRA, unsuccessfully attempted to withdraw from his employer's plan.¹²⁸ In November of 1975, he was advised that he would probably be laid off in the immediate future. He then established an IRA even though he was still a participant in his employer's plan. He was laid off in January of 1976 and, since he had not completed the ten years of service necessary to receive a vested pension benefit, all of his rights under his employer's plan were forfeited.¹²⁹

In concluding that Orzechowski was an active participant during 1975, the Tax Court relied primarily upon the following statement in the report of the House Committee on Ways and Means:

An individual is to be considered an active participant in a plan if he is accruing benefits under the plan even if he only has forfeitable rights to those benefits. Otherwise, if an individual were able to, *e.g.*, accrue benefits under a qualified plan and also make contributions to an individual retirement account, when he later becomes vested in the accrued benefits he would receive tax-supported retirement benefits for the same year, both from the qualified plan and the retirement savings deduction.¹³⁰

Since Orzechowski had clearly been accruing benefits throughout 1975 which were later forfeited in 1976, the court concluded that, despite the harshness of the result under the circumstances of the case, it had no option but to disallow Orzechowski the deduction.¹³¹ The court went on to review the legislative history of the six percent penalty tax imposed on excess IRA contributions by section 4973, and concluded that since Orzechowski could not, as an active participant, have made any IRA contribution in 1975, his entire contribution was an excess contribution subject to the penalty. Five dissenters, though agreeing that Orzechowski was an active participant, felt that the application of the penalty tax in his case was "abhorrent" and suggested that a distinction be drawn between employees who over-contribute to an existing IRA and those who are ineligible to establish an IRA at all

the Tax Court's understanding of the IRA provisions is *Guest v. Commissioner*, 72 T.C. 768 (1979), which considered constitutional objections to various provisions.

128. It is common for pension plan participation to be mandatory, since plans must generally cover a certain percentage of employees in order to qualify under I.R.C. § 401(a). See I.R.C. §§ 401(a)(3), 410. The fact that many employees are forced to participate in a plan from which they derive only minimal benefit and are thereby rendered ineligible to establish an IRA has been a principal criticism of the active participant rules.

129. See text accompanying notes 159-69 *infra* for a discussion of vesting and forfeiture.

130. H.R. Rep. No. 807, 93rd Cong., 2d Sess. 124 (1974), *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 4794.

131. 69 T.C. at 757.

because of their active participation in another plan.¹³² This distinction, which appears to have been based more on sympathy for Orzechowski than on any plausible reading of the statute, was rejected by both the majority of the Tax Court and the Second Circuit, which affirmed *Orzechowski* in a brief opinion.¹³³

The Tax Court was undoubtedly correct in concluding that Orzechowski, who was not laid off until 1976, was an active participant during 1975. However, the flood of active participant cases in the Tax Court which followed *Orzechowski* made no attempt to explore the definition of active participant further. A large number of these cases involved pension plan participants who were laid off during the same year that they attempted to establish an IRA, and whose rights were not only forfeitable, but actually forfeited.¹³⁴ Nevertheless, these cases all followed the same pattern. Pursuant to the Tax Court's small case procedure, the majority of cases were assigned to a special trial judge for resolution,¹³⁵ and such judges invariably recited the facts briefly,

132. *Id.*

133. 592 F.2d 677 (2d Cir. 1979). The dissent in the Tax Court relied heavily upon the fact that under the IRA provisions as originally drafted, a taxpayer who established an IRA under the mistaken impression that he was eligible to do so could not withdraw the contribution without having his contribution again included in his income and paying an additional 10% penalty tax on early withdrawals. This would occur because the statutory grace period for withdrawal of excess contributions would probably have expired by the time the taxpayer's eligibility was determined. See I.R.C. §§ 408(d)(4), 4973(b)(2). Thus, the dissent felt that Congress could not also have intended to impose the six percent excess contribution penalty, particularly since the penalty is assessed every year until the contribution is withdrawn. See I.R.C. § 4973(b)(2). This problem was resolved in part by the Revenue Act of 1978, which enacted a special grace period and directed the Service to refund all penalties and taxes based on distributions which corrected excess contributions. Revenue Act of 1978, Pub. L. No. 95-600, § 157(c), 92 Stat. 2763 (1978) (codified at I.R.C. § 408(d)(5)). For a graphic example of the severity with which the Tax Court enforces the penalty, see *Johnson v. Commissioner*, 74 T.C. 1057 (1980), *aff'd*, 661 F.2d 53 (5th Cir. 1981), imposing the penalty on a taxpayer who, realizing he should not have contributed to an IRA, did not claim the deduction and reported the IRA's earnings in his income. See also *Mitchell v. Commissioner*, 42 T.C.M. (CCH) 607 (1981) (penalty imposed on taxpayer who mistakenly established an IRA even though he was concededly eligible to establish a Keogh Plan).

134. See, e.g., *Randall v. Commissioner*, 41 T.C.M. (CCH) 296 (1980); *Cavana v. Commissioner*, 40 T.C.M. 1169 (CCH) (1980); *Andalman v. Commissioner*, 40 T.C.M. (CCH) 773 (1980); *Cooper v. Commissioner*, 38 T.C.M. (CCH) 1023 (1979). The foregoing examples are not intended as a complete list. The abbreviated nature of the opinions in these cases, and the fact that the courts did not regard forfeiture as relevant to an employee's right to establish an IRA, make it difficult to determine whether the taxpayers in many of the cases had forfeited their benefits. However, the fact patterns of many of the cases make it reasonable to infer that a forfeiture occurred, particularly where a taxpayer, like Foulkes himself, quit his job in a year which preceded the effective date of the limitations on forfeiture of ERISA. See text accompanying notes 159-60 *infra*. The facts of *Cooper* were conceded by the Seventh Circuit to be indistinguishable from those of *Foulkes*. 638 F.2d at 1108.

135. Active participant cases are technically not eligible for the ordinary small case procedure as defined in I.R.C. § 7463 and rule 171 of the Tax Court Rules of Practice and Procedure, 60 T.C. 1145 (1973), as that procedure applies only to income, estate and gift taxes and the I.R.C. § 4973 penalty tax is an excise tax. However, rule 180, 60 T.C. 1148 (1973), allows the Chief Judge of the

cited *Orzechowski*, expressed regret at the harshness of the law and entered judgment for the Commissioner. Not one of these cases occupies more than three pages in the reporters, and not one resulted in a victory for the taxpayer.¹³⁶

This pattern was broken by the Seventh Circuit in *Foulkes*. John Foulkes left his job in May of 1975 and thereby forfeited all of his benefits under his employer's pension plan. He established an IRA in the same year. The Tax Court, with the inevitable citation to *Orzechowski*, concluded that since Foulkes had been accruing benefits through May of 1975, he was an active participant for part of 1975, despite the fact that those benefits were later forfeited.¹³⁷ The Seventh Circuit, on the other hand, felt that the fact that Foulkes forfeited his pension during the same year in which he attempted to establish an IRA distinguished the case from *Orzechowski*, in which the pension benefits had been only forfeitable, rather than forfeited, by the end of that year.

The Seventh Circuit acknowledged that the Tax Court's conclusion that Foulkes had been an active participant "for any part of" 1975 was a reasonable reading of the statute,¹³⁸ but felt that section 219(b)(2)(A) must be interpreted in light of Congress' intent to preclude an employee from obtaining a benefit from both an IRA and a qualified pension plan during the same year.¹³⁹ The court was, however, compelled to recognize the legislative history relied upon in *Orzechowski* which indicated that a participant is ineligible to establish an IRA in a year in which he derives a benefit from a plan, even if his benefit is forfeitable. Thus, it concluded that the term "active participant" must be interpreted to mean one who, during the year in which he attempts to make an IRA contribution, has the *potential* for obtaining a benefit from a qualified pension plan.¹⁴⁰ This determination, the court held, could only be made by taking into account all events occurring during the year, including, in Foulkes' case, his forfeiture of all benefits.

There is no doubt that the Seventh Circuit's interpretation of the active participant rule is more consistent with the underlying congressional purpose of section 219(b)(2)(A) than is that of the Tax Court.

Tax Court to assign cases which are not small tax cases to a special trial judge for hearings and, pursuant to General Order No. 6, 69 T.C. xv (1978), this procedure has generally been invoked for active participant cases.

136. See note 126 *supra*.

137. 37 T.C.M. (CCH) 1851-49 (1978).

138. 638 F.2d at 1110.

139. *Id.* at 1109-10.

140. *Id.* at 1109.

Nevertheless, the determination of whether an employee has the potential for deriving a benefit from a plan in any given year will not always be as easy to make as it was in *Foulkes*.¹⁴¹ In order to consider the consequences which may flow from *Foulkes*, it is necessary to explore the different types of interests which participants may have in different types of qualified plans.

There are two basic types of qualified retirement plans: "defined benefit plans"¹⁴² and "defined contribution plans."¹⁴³ In a defined benefit plan (the traditional type of pension plan), the amount of monthly retirement pension which a participant will receive is fixed in advance and the employer contributes to the plan the amount which an actuary determines is necessary to fund that pension.¹⁴⁴ In a defined contribution plan (such as a profit-sharing plan),¹⁴⁵ the employer contributes an amount to the plan each year, and the amount of retirement pension which a participant ultimately receives depends upon the amount of the contribution that is allocated to his account and the success of the plan's investments.

Two basic factors must be taken into account in determining the benefit which a participant derives from either type of plan. These factors are accrual and forfeiture. Presumably, under the Seventh Circuit's rationale, a participant would not have the potential to derive a benefit from a plan in a year in which he either failed to accrue a bene-

141. The Service stipulated that *Foulkes* had no potential for deriving a benefit from a plan in 1975. *Id.* at 1110.

142. I.R.C. § 414(j).

143. I.R.C. § 414(i).

144. The permissible actuarial assumptions which may be used in computing the employer's contribution are set forth in I.R.C. § 412 (defining the minimum required contribution) and I.R.C. § 404(a)(1) (defining the maximum deductible contribution).

145. A profit-sharing plan is a plan which provides for contributions out of the employer's current or accumulated earnings, the amount of which may be determined in the discretion of the employer. Its primary purpose is to enable employees to share in the employer's profits, rather than to provide retirement income. Treas. Reg. § 1.401-1(b)(1)(ii). A stock bonus plan is also a defined contribution plan designed to allow employees to share in the profitability of the employer. It differs from a profit-sharing plan in that contributions need not be limited to current or accumulated earnings and distributions are made in the form of employer stock. Treas. Reg. § 1.401-1(b)(1)(iii). Profit-sharing and stock bonus plans are usually classified together and distinguished from defined contribution pension plans, commonly referred to as "money purchase" pension plans. Money purchase pension plans are true pension plans in that their primary purpose is providing retirement income and the employer has an annual requirement to contribute to them. Treas. Reg. § 1.401-1(b)(1)(i). The annual contribution to a money purchase pension plan is usually stated as a percentage of compensation, although there is a special type of money purchase pension plan, known as a "target benefit" plan, in which the amount of benefit each employee is to receive is defined and the necessary annual contribution to fund that benefit is initially calculated. However, the annual contribution requirement remains fixed and the actual benefit paid depends on the balance in the participant's account, whereas in a true defined benefit plan the funding requirement changes from year to year based on investment experience, changes in actuarial assumptions, etc. See Rev. Rul. 76-464, 1976-2 C.B. 115.

fit, or accrued a benefit but forfeited it before the end of the year. However, particularly since the enactment of ERISA, it is not always easy to ascertain when one of these events has taken place.

Accrual is, properly speaking, a concept that relates only to defined benefit plans.¹⁴⁶ The amount of benefit a participant receives from a defined benefit plan depends in part on the participant's length of service; accordingly, the participant is said to accrue a portion of his benefit for each period of service that he completes. For example, a typical union pension plan may provide that union members are to receive a retirement pension of ten dollars per month for each year of service completed with the employer. A participant in such a plan would accrue a ten dollar per month benefit for each year of service which he completes.¹⁴⁷ Because a defined contribution plan has no formula defining the amount of benefit received, there is, strictly speaking, no accrual of benefits under such a plan. However, the making of contributions to a defined contribution plan is in a sense analogous to the accrual of benefits, because the contributions are added to a participant's account and increase the amount of benefit which he ultimately receives.¹⁴⁸

In the case of "accruals" under a defined contribution plan, section 1.219-2 of the regulations, which defines the term "active participant," appears to be consistent with the Seventh Circuit's approach. The regulation provides that an employee is only considered to be an active participant in a defined contribution plan if an amount is added to his account sometime during the year.¹⁴⁹ However, some Tax Court cases,

146. I.R.C. § 411(b), which specifies permitted accrual formulae, applies only to defined benefit plans. See I.R.C. § 411(a).

147. Such a plan is known as a unit benefit plan. Union-negotiated plans typically provide for the accrual of a fixed amount each year regardless of compensation, whereas nonunion plans often provide that the accrual is dependent either on compensation received during the year (a "career pay plan") or on average compensation received during a stated period of time, such as the final three years of employment (a "final average plan"). Plans in which the benefit is not based upon the period of employment (although there may be a minimum length of employment required to accrue a benefit) are known as "flat percentage" (if the benefit is stated as a percentage of compensation) or "flat benefit" plans.

148. Some of the regulations under ERISA treat the balance in a participant's account in a defined contribution plan as an "accrual." See Treas. Reg. § 1.411(a)-7(a)(2).

149. In fact, Treas. Reg. § 1.219-2(c) provides that an employee is an active participant in a money purchase plan in the year in which a contribution is *allocated* to his account, while Treas. Reg. § 1.219-2(d) provides that an employee is a participant in a profit-sharing or stock bonus plan in the year in which a contribution is actually *paid* to his account (unless the contribution is supplementary to a contribution paid and allocated in a previous year). See Treas. Reg. § 1.219-2(d)(2). This distinction may cause problems, as many employers follow the practice of allocating their annual contribution among participants as of the last day of the year, but not actually paying it until the following year, because I.R.C. § 404(a)(6) allows a contribution to be deducted if made before the employer's tax return for the year is due. If an employer maintains both a profit-

without discussing the regulations, have held employees to be active participants in defined contribution plans in years in which they received no contribution allocations.¹⁵⁰ These cases can only be viewed as a product of the cursory treatment the Tax Court gives active participant cases in general. They are wrongly decided, and the rule may be taken as settled that an employee is not an active participant in a de-

sharing and a money purchase pension plan and contributes to both simultaneously, its employees thereby become active participants in two years because of what is, in practical effect, one contribution. The reason for the distinction is apparently that the obligation to contribute to a money purchase plan is fixed at the end of a year, so that it is reasonable to determine an employee's active participant status at that time, whereas profit-sharing and stock bonus contributions may be discretionary, and therefore an employee's active participant status should not be determined until a contribution is actually made.

150. See, e.g., *Andalman v. Commissioner*, 40 T.C.M. (CCH) 773 (1980). The active participant regulation, as originally proposed on February 21, 1975, provided that an employee was an active participant if either the employer was obligated to make a contribution to the plan on the employee's behalf or if the employer would be obligated to allocate a portion of its contribution to the employee if a contribution were made. Prop. Treas. Reg. § 1.219-1(c)(ii) (A), 40 Fed. Reg. 7661 (1975). This provision would have made an employee an active participant in a profit-sharing or stock bonus plan in a year in which the employer decided to make no contribution, which was clearly unfair. The proposed regulation was repropoed on March 23, 1979, 44 Fed. Reg. 17754 (1979), in substantially the same form in which it was finally adopted on August 7, 1980. T.D. 7714, 1980-2 C.B. 83. Even under the original proposal, however, an employee who, like *Andalman*, had no right to have a contribution allocated to his account because he was not employed on the last day of the year should not be considered an active participant. See text accompanying note 151 *infra*. This provision was not even discussed by the Tax Court, which relied solely on *Orzechowski v. Commissioner*, 69 T.C. 750 (1978), *aff'd*, 592 F.2d 677 (2d Cir. 1979). The Service had announced that taxpayers could rely on the proposed regulation pending the issuance of a final regulation. See Technical Information Release-1425 (Dec. 12, 1975). Thus, *Andalman* apparently lost his case through his failure—and that of the special trial judge—to keep up on the Service's technical information releases.

An even more troubling case is *Smith v. Commissioner*, 42 T.C.M. (CCH) 1621 (1981), a post-*Foulkes* case in which the facts were substantially identical to those in *Andalman*. In addition to completely ignoring the proposed regulations, as it had done in *Andalman*, the Tax Court in *Smith* distinguished *Foulkes* by holding that *Smith* had received a "potential benefit" from his employer's plan in the year in which he terminated his employment because if he were reemployed and new contributions were made to his account, his pretermination service could be counted for vesting purposes under the "rule of parity" of I.R.C. § 411(a)(6)(D). Thus, *Smith* appears to take the position that an employee may be an active participant in a year in which he accrues no benefit, but increases his vested percentage in a benefit which either previously accrued or might accrue in the future. This holding is based on a fundamental misunderstanding of the difference between vesting and accrual. A plan participant who completes a required vesting period does not thereby acquire a new retirement benefit, but merely satisfies a necessary condition for the receipt of the benefit previously accrued. Under the *Smith* court's theory, the same benefit could cause an employee to be an active participant in several different years—the year in which it accrues, and each year in which a portion of it vests. This would be contrary not only to Treas. Reg. § 1.219-2(c) and Treas. Reg. § 1.219-2(d), see note 149 *supra*, but also to each other provision of the regulations that provides that a participant is not an active participant in a year in which, for whatever reason, he does not accrue a benefit, since his service during that year may always increase his vested interest in a benefit accrued in another year. See notes 153 & 158 *infra*. In fact, since the general rule is that all service must be counted for vesting purposes, with certain limited exceptions, under an extreme reading of *Smith* an employee whose employer maintains a plan would always be an active participant, since it is always possible that the employee will accrue a benefit at some later time. See I.R.C. § 411(a)(4).

defined contribution plan if no money is added to his account in the plan during the year, regardless of whether he is covered by the plan's eligibility provisions during the year. This rule will to some degree alleviate the problem of mid-year employment terminations for participants in defined contribution plans, since such plans frequently require that a participant be employed on the last day of a year in order to receive a share of that year's contribution.¹⁵¹

However, there is no such consensus with regard to defined benefit plans under which true accruals take place. Section 1.219-2 of the regulations states the general rule that an employee is an active participant in a defined benefit plan if he meets the plan's eligibility requirements, regardless of whether he actually accrues a benefit during the year.¹⁵² An exception is made for plans which are integrated with Social Security in which the participant does not earn enough to accrue a benefit, apparently in recognition of the fact that many employees are nominal participants in plans which in fact benefit only highly paid employees through use of integration.¹⁵³ However, there are many situations other than integration in which an employee may be covered by a plan's eligibility provisions but not accrue benefits. Most commonly, many plans provide that an employee must work at least 1,000 hours

151. Such provisions are generally permitted. See Department of Labor Regulations, 29 C.F.R. § 2530.200b-1(b) (1980). However, if a plan denies a share of the year's contributions to employees who have completed a "year of service" see note 161 *infra*, because they are not employed on the last day of the year, and such provision has the effect of discriminating in favor of officers, shareholders or highly compensated employees, as may occur if a plan has high turnover among low-paid employees, it may cause the plan to be disqualified. See Rev. Rul. 76-250, 1976-2 C.B. 124. Accordingly, many plans provide that an employee who has completed a year of service is entitled to a contribution even if he leaves before the last day of the year.

Most of the rules governing a plan's permissible vesting, accrual and participation provisions are contained in both I.R.C. §§ 410, 411 and in the "labor" portion of ERISA, 29 U.S.C. §§ 1051-1061 (1976 & Supp. III 1979). This article will cite the applicable Code provisions only and not the parallel ERISA provisions. However, a number of the regulations which are applicable in the interpretation of I.R.C. §§ 410, 411 were originally issued by the Department of Labor. Pursuant to Reorganization Plan No. 4, 43 Fed. Reg. 47713 (1975), 92 Stat. 3793 (1975), the Treasury Department now has jurisdiction over such regulations.

152. Treas. Reg. § 1.219-2(b)(1).

153. *Id.* "Integration" is based on the theory that each employee's private pension plan benefits and Social Security benefits should be considered together, or "integrated," in determining whether a plan discriminates in favor of highly compensated individuals. Since Social Security benefits are based solely on earnings up to the contribution and benefit base established under 42 U.S.C. § 230 (1976), this allows an integrated plan to disproportionately favor earnings above that base. The statutory basis for integration is found in I.R.C. § 401(a)(5), and the tests which are followed in determining if a plan is properly integrated are found in Treas. Reg. § 1.401-3(e) and Rev. Rul. 71-446, 1971-2 C.B. 187. The existing active participant regulation technically deals only with employees who are participants in an "excess" integrated plan in which benefits are based on compensation in excess of the Social Security base wage. An amendment to the regulation dealing with "offset" plans, in which a participant's benefit is reduced by Social Security benefits received, was proposed on July 14, 1981. See 46 Fed. Reg. 36198 (1981).

for the employer during a year in order to accrue a benefit for that year.¹⁵⁴ The regulation appears to consider such employees active participants. It seems to follow from the rationale of *Foulkes* that the Seventh Circuit would not consider them active participants, since they derive no benefit from the plan for the year. The Tax Court has not addressed the issue and, considering its track record, it would probably uphold the regulation, if it bothered to discuss it at all, although it would no doubt apologize for the harshness of the rule.¹⁵⁵

In summary, the regulation's position on accrual under defined benefit plans is not only inconsistent with its position on defined contribution plans, but appears to ignore the word "active" in the phrase "active participant"; the Seventh Circuit's opinion provides a basis for considering the regulation invalid.¹⁵⁶

Another accrual issue arises where a participant in a defined benefit plan has fully accrued his benefit. Some plans provide that a benefit is fully accrued after a certain period of time, such as thirty years of service.¹⁵⁷ An employee who continues to work after thirty years can derive no further benefit from his employer's plan, and thus under the literal terms of the *Foulkes* rationale would be eligible to establish an IRA. On the other hand, the Seventh Circuit could reasonably assume that Congress did not intend for an employee who had fully accrued a benefit from an employer's plan to be eligible for an IRA, in that the basic purpose of IRAs was to provide retirement benefits for those who

154. A plan is required to compute service for accrual purposes on a "reasonable and consistent basis," I.R.C. § 411(b)(3)(A), but may disregard any year in which an employee works fewer than 1,000 hours. I.R.C. § 411(b)(3)(C).

There is another situation in which an employee may be eligible to participate in a plan but not accrue any benefits, which can act as a trap for the unwary. The maximum period of service a plan may generally require as a requirement for participation is one year of service. I.R.C. § 410(a)(1)(A)(ii). Furthermore, an employee must be made a participant within six months after he completes the year of service. I.R.C. § 410(a)(4). Unlike the computation of years of service for vesting and years of participation for accrual, which can use any reasonable computational period, years of service for eligibility must include the first twelve months during which an employee is employed. Department of Labor Regulations, 29 C.F.R. § 2530.202-2(a) (1980). Thus, an employee may become a participant sometime in the middle of the plan's accrual computational period, too late to complete 1,000 hours of service after beginning participation. In fact, many plans make a new employee a participant on the last day of the plan year in which he completes his eligibility period, but begin accruals in the following year. Such an employee is arguably an active participant for one day during the year, and therefore ineligible to establish an IRA.

155. See text accompanying note 131 *supra*.

156. In fact, the Seventh Circuit explicitly stated that it would not follow the proposed regulation if adopted, although it was referring to the original proposals described in note 150 *supra*. 638 F.2d at 1110 n.17.

157. The various limitations on the length of time that can be required for a full accrual are set forth in I.R.C. § 411(b)(1).

are not covered by an employer's plan.¹⁵⁸

Assuming, however, that an employee has accrued a benefit during some part of a tax year, the possibility remains that he may forfeit that benefit later in the year. This, of course, was the situation in both *Foulkes* and *Orzechowski*, and it appears to be the one most frequently litigated in the Tax Court. *Foulkes* dealt with the simplest possible case because the year involved was 1975. Due to the staggered effective dates of the various provisions of ERISA, the IRA provisions went into effect for 1975,¹⁵⁹ but many of the substantive restrictions upon the operation of a qualified pension plan, including limitations on forfeiture, were postponed until 1976 for plans already in existence when ERISA was enacted.¹⁶⁰ Accordingly, when *Foulkes* quit his job in May of 1975, he permanently and irrevocably forfeited all of his accrued benefits under his employer's pension plan, which made it easy for the Seventh Circuit to conclude that he had no possibility of ever deriving a benefit from that plan as of the end of 1975. However, under ERISA, an employee who forfeits any portion of his benefit upon terminating his employment must have the forfeited benefit restored to him if he is reemployed before incurring a "break in service."¹⁶¹ Thus, if *Foulkes*

158. The Service has ruled that an employee who has fully accrued his maximum benefit is nevertheless still an active participant. Private Letter Ruling 8016094 (Jan. 24, 1980). It should also be noted that the benefit of an employee who has ceased accruals may continue to increase because the amount of the benefit is tied to his compensation during his final years of employment. In the context of a "frozen" plan, discussed below, the regulation takes the position that such increases cause the employee to be an active participant. This position would appear inconsistent with the theory that Congress was primarily concerned with accruals of new benefits, not increases in value of benefits already accrued. For example, it has never been suggested that a defined contribution plan participant should be considered an active participant in a year merely because investment returns increase the value of his benefit. The regulation also provides that an employee who has ceased accruing benefits because he has passed the age at which benefit accrual ceases (typically the normal retirement age) ceases to be an active participant. Treas. Reg. § 1.219-2(b)(4). This distinction, whatever the reason behind it, is of limited value to most over-retirement age employees, as an employee may not contribute to an IRA in or after the year in which he reaches age 70½. I.R.C. § 219(b) (amended 1981) (current version at I.R.C. § 219(d)(1)).

Before leaving the topic of accruals, two other exceptions to active participant under Treas. Reg. § 1.219-2 should be noted: participants in a "frozen" plan in which accruals have ceased for all participants (but not if the amount of the benefit to be paid may vary with future compensation), Treas. Reg. § 1.219-2(b)(3), and employees who choose not to participate in a voluntary plan, Treas. Reg. § 1.219-2(f). The proposed amendments to § 1.219-2, see note 153 *supra*, would also exempt certain persons covered by governmental plans on a part-time basis (*i.e.*, armed forces reservists and volunteer firemen).

159. ERISA, Pub. L. No. 93-406, § 2002(i), 88 Stat. 971 (1974).

160. *Id.* § 1017(b), 88 Stat. 932 (1974). For new plans, the vesting rules went into effect on the date of enactment of ERISA. *Id.* § 1017(a).

161. Technically, ERISA provides that all of an employee's "years of service" (generally a computational period in which he works for at least 1,000 hours of service) with an employer must be counted for vesting purposes except, *inter alia*, for years prior to the computational period in which he incurs a break in service. I.R.C. §§ 411(a)(4)(D), 411(a)(6). In practice, this means that an employee who quits and is rehired without incurring a break in service is treated for vesting

had quit his job in May of 1976 instead of May of 1975, he may still have had the potential of realizing a benefit from his employer's plan for 1976, and the Seventh Circuit would have had a much harder case. How much more difficult the case would have been would have depended upon the method used by his employer's plan to compute breaks in service.

A break in service is generally defined as a "computational period" during which a participant completes 500 or fewer hours of service.¹⁶² Assume Foulkes' employer's plan, after amendment to comply with ERISA, uses a calendar year both as its fiscal year and for purposes of computing breaks in service.¹⁶³ In this situation, it is easy to ascertain at the end of the year whether a terminated employee has any possibility of having his forfeited benefits restored to him. Thus, if Foulkes quit his job in May of 1980 rather than 1975, all that would be necessary would be to add up the number of hours that he worked in 1980 prior to quitting. If it were 500 hours or less, he would be able to establish an IRA in 1980. It will, however, be recalled that, although an employee need only work more than 500 hours to avoid a break in service, many plans require him to work at least 1,000 hours in a year in order to accrue a benefit. In such a plan, an employee who works between 500 and 1,000 hours in a year before quitting would still have a chance of receiving benefits accrued in prior years, but would accrue no benefit for the current year, and presumably under *Foulkes* could establish an IRA.¹⁶⁴

purposes as though he never quit (although, if he works for fewer than 1,000 hours of service during any year because of the fact that he was employed for only part of the year, the year will not be considered a year of service). There is one important exception: if an employee is partially vested when he quits and receives a distribution of the vested portion of his account, he may be required to repay the distribution upon being reemployed as a condition to having his forfeited benefit restored. See I.R.C. § 411(a)(7)(C); Treas. Reg. § 1.411(a)-7(d).

Technically, when an employee terminates his employment, a defined contribution plan may either provide for an immediate forfeiture with a restoration of benefits if he is reemployed without incurring a break in service, or for a delayed forfeiture which does not become effective until a break in service is incurred. Treas. Reg. § 1.411(a)-7(d)(2)(iv). Courts should avoid adding further complexity to this area by regarding both types of forfeiture as equivalent for active participant purposes.

The vesting restrictions comprise one of the most complex areas of ERISA, and the foregoing is intended as no more than a brief sketch of the rules relevant to the active participant issue.

162. I.R.C. § 411(a)(6)(A). For the rules governing the calculation of hours of service, see Department of Labor Regulations, 29 C.F.R. § 2530.200b-2 (1980).

163. A plan may use any 12-month period as a vesting computation period, provided it does not result in an "artificial postponement" of vesting. Department of Labor Regulations, 29 C.F.R. § 2530.203-2 (1980). The plan's fiscal year (which is often, but is not required to be, the same as the employer's) is probably the most common computational period.

164. This example assumes that the vesting and accrual computational periods are the same, which they need not be. See Department of Labor Regulations, 29 C.F.R. § 2530.200b-1(a) (1980).

Assume, on the other hand, that the plan's computational period for determining breaks in service is based not on its accounting period, but upon anniversaries of the day on which the employee was hired. Now assume that Foulkes was originally hired on a February 1, and again leaves the job in May of 1980, having worked fewer than 500 hours since February 1, 1980. Technically, he has not incurred a break in service as of December 31, 1980 because he has until January 31, 1981 to complete his more than 500 hours. Presumably, the Seventh Circuit would regard him as ineligible to establish an IRA, since it is still possible that he could eventually receive the benefit that he accrued in 1980.

But what if he quits on February 1, 1980, having completed *no* hours during the computational period? Then, he would not have incurred a break in service by December 31, 1980, but in order to avoid a break in service it would be necessary for him to work twenty-hour days throughout the month of January in order to complete his more than 500 hours by January 31, 1981. It may thus be said that by any practical standard he has no possibility of receiving the benefit which he accrued in 1980. However, if the court were to rule that Foulkes was therefore eligible to establish an IRA in 1980, it would be only a matter of time before it was asked to determine whether it is possible for an employee to work, for example, 200 hours in a single month, and it would wind up taking evidence on the availability of overtime during the month of January in a particular industry. In order to avoid being drawn into such a morass, the court would presumably establish the rule that an employee must have actually incurred a break in service within a year in order to be eligible to contribute to an IRA in that year.

It should be noted, however, that many plans which do not use their fiscal year for computational purposes also do not use the hours of service method at all, but rather use the "elapsed time" method of computing service. Under the elapsed time method, an employee is given credit for service solely for the length of time that he is actually employed, regardless of how many hours he works.¹⁶⁵ In order for an employee to incur a break in service under the elapsed time method, a full year must pass after he terminates employment.¹⁶⁶ Thus, an em-

165. Treas. Reg. § 1.410(a)-(7)(a)(1).

166. The equivalent of a break in service under the elapsed time method is a "one-year period of severance," defined as a 12-month period ending on the anniversary of the day an employee terminates employment during which he does not perform any hours of service. Treas. Reg. § 1.410(a)-(7)(d)(4).

ployee under the elapsed time method would *never* incur a break in service in the same year in which he quit and would never be eligible for the benefits of the *Foulkes* decision.

Similar problems arise if a plan uses its fiscal year to compute breaks in service, but its fiscal year is not the calendar year. In this regard, it should be noted that the regulation provides that an employee is ineligible to establish an IRA in a year if he is an active participant in a plan for any plan year which ends within the year.¹⁶⁷ Thus, if *Foulkes* were a participant in a plan with a January 31 fiscal year, and if as of January 31, 1980 he had accrued and not forfeited a benefit under that plan for its fiscal year ending on that date, he would be ineligible to establish an IRA in 1980, and anything which occurred after that date would be relevant only to his eligibility in 1981. This rule finds little support in either the literal language of section 219(b)(2)(A) or *Foulkes*, but it may be useful in avoiding some of the kinds of problems discussed above.

It thus appears that if *Foulkes* is interpreted as applying only to employees who both forfeit their benefits and incur a break in service—and the Tax Court has already announced that it agrees with this interpretation¹⁶⁸—the break in service rules will effectively preclude a large number of terminating employees from eligibility to contribute to an IRA. It should also be kept in mind that the foregoing discussion has assumed that an employee who terminates his employment forfeits his entire benefit. In fact, many plans provide that benefits vest over a period of years,¹⁶⁹ and an employee who accrues a benefit during a

167. The regulation is not concerned with the operation of the vesting rules, since the Service views vesting as irrelevant to active participant status. Accordingly, this rule is applied only to defined benefit plans, with regard to which an employee's eligibility to participate during a plan year is determinative, Treas. Reg. § 1.219-2(b), and money purchase plans, with regard to which the allocation of contributions to an employee's account for a plan year is determinative. Treas. Reg. § 1.219-2(c). It does not apply to profit-sharing or stock bonus plans, since the regulation takes the position that an employee is an active participant in the calendar year in which a contribution is actually made, and plan years are therefore irrelevant. Treas. Reg. § 1.219-2(d).

168. *Chapman v. Commissioner*, 77 T.C. No. 33 (Aug. 24, 1981). See also *Boykin v. Commissioner*, 42 T.C.M. (CCH) 803, 805 (1981).

169. The type of vesting assumed in the discussion, in which 100% of a participant's benefit vests after a specified period of time, is known as "cliff" vesting, and the maximum length of service that can be required for cliff vesting under ERISA is 10 years. I.R.C. § 411(a)(2)(A). So-called "10-year cliff" (or simply "10-cliff") vesting is common in union plans and plans of large public corporations, but most other plans use some form of graduated vesting schedule. The graduated vesting schedules permitted under ERISA are "5- to 15-year vesting", I.R.C. § 411(a)(2)(B), and "rule of 45 vesting". I.R.C. § 411(a)(2)(C). Any plan whose vesting schedule is at least as rapid as one of these alternatives meets the minimum vesting standard of ERISA. However, in addition, I.R.C. § 411(d)(1) provides that a plan will not qualify if its vesting schedule has the effect of discriminating in favor of officers, shareholders and highly compensated employees, as may occur if a disproportionately large number of low-paid employees forfeit their benefits due to

year and then quits and incurs a break in service during the year, but because of previous service forfeits only ninety percent of his accrued benefit, would presumably still be considered an active participant.

Effective in 1982, the Economic Recovery Tax Act of 1981, in the name of increasing savings incentives, abolished the active participant rule and allows anyone with sufficient compensation to establish an IRA.¹⁷⁰ However, the great number of IRA cases already decided by the Tax Court arise almost exclusively out of 1975 and 1976, and it is a reasonable inference that the years 1977 through 1981 will also yield a bumper crop of IRA cases for the courts to decide.

The overwhelming impression received from the IRA cases already reported is that the great majority of taxpayers simply assume that they may establish an IRA at any time that they are not working for a company which covers them with a pension plan, regardless of whether they are covered by the technical definition of active participant that has been developed by the regulations and the Tax Court. In such a situation, the Seventh Circuit's decision in *Foulkes* may save a few taxpayers from inadvertent violations of section 219(b)(2)(A), and it is to be hoped that Congress' abandonment of the active participant requirement may prompt other courts to adopt the Seventh Circuit's more reasonable approach, although the Fifth Circuit has already declined to do so.¹⁷¹ It seems likely, however, that most taxpayers who

employee turnover. Because of this rule, a very common vesting schedule is "4/40 vesting" (40% vested after four years, 5% per year for the next two years, and 10% per year thereafter), which the Service has treated as a safe harbor for advance ruling purposes. See Rev. Proc. 75-49, 1975-2 C.B. 589, modified by Rev. Proc. 76-11, 1976-1 C.B. 550. Whether 4/40 should be an absolute safe harbor (except in the case of an employer who deliberately fires employees to prevent vesting) is one of the most hotly-disputed current issues in pension law. See Prop. Treas. Reg. § 1.411(d)-1, 45 Fed. Reg. 24201, 39869 (1980).

170. ERTA, Pub. L. No. 97-34, § 311, 95 Stat. 277 (1981), reprinted in [1981] U.S. CODE CONG. & AD. NEWS 105 (Supp. 6). The Act also allows a participant in a qualified plan to deduct certain voluntary contributions made to the plan (subject to the same limits as IRAs), eliminates the 15% of compensation rule and allows contribution, up to the full amount of compensation, and raises the overall ceiling on contributions to \$2,000 (\$2,250 for a taxpayer with a nonworking spouse).

171. *Johnson v. Commissioner*, 661 F.2d 53 (5th Cir. 1981): The court commented on the harshness of the law, but did not consider it worth the effort to examine the issue, contenting itself with the flat statement that if the facts in *Foulkes* could not be distinguished, the Seventh Circuit's reasoning would not be followed. The Tax Court, in *Chapman v. Commissioner*, 77 T.C. No. 33 (Aug. 24, 1981), reserved the question of whether it would accept *Foulkes* or adhere to its previous position outside of the Seventh Circuit. In several recent cases, the Tax Court has avoided the *Foulkes* issue by requiring taxpayers to prove that they had no possibility of deriving a benefit from their plan, which, as unsophisticated *pro se* litigators, the taxpayers have been unable to do. See *Smith v. Commissioner*, 42 T.C.M. (CCH) 1621 (1981); *Bogaards v. Commissioner*, 42 T.C.M. (CCH) 1177 (1981); *Boykin v. Commissioner*, 42 T.C.M. (CCH) 803 (1981). Interestingly, in *Turner v. Commissioner*, 42 T.C.M. (CCH) 1434 (1981), the Tax Court, without mentioning *Foulkes*, departed from its strict construction approach by holding that an Air Force officer was

are saved by *Foulkes* will be as blissfully unaware that they were within the *Foulkes* exception to active participant status as they were unaware that they could have been considered an active participant in the first place.

DEVELOPMENTS IN THE LAW

Tax Benefit Rule

During this last term, the Seventh Circuit also heard two cases which dealt with the ever-elusive tax benefit rule.¹⁷²

In a per curiam decision, the court affirmed the panel decision in *Home Mutual Insurance Co. v. Commissioner*.¹⁷³ It held that the "tax benefit rule may not be invoked unless the items sought to be excluded from taxation are asserted to be taxable only by means of the exclusionary aspect of the tax benefit rule."¹⁷⁴

In *Hillsboro National Bank v. Commissioner*,¹⁷⁵ the court, for the second time in two years, was presented with a case arising out of the abolition of the Illinois personal property tax. Just last year, the court had faced the same issue in *First Trust & Savings Bank of Taylorville v. Commissioner*.¹⁷⁶ Briefly stated, the Hillsboro National Bank, in keep-

not an active participant in a government plan when, by statute, he would be required to retire before becoming eligible for a pension.

172. One of the most commonly accepted definitions of the tax benefit rule can be found in one of the leading cases on the subject: "The tax benefit rule provides that an item properly offset against gross income in determining one year's tax liability is includable in gross income when it is recovered in a subsequent year." *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440, 446 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979).

This definition represents an oversimplification of a rule which has presented many complicated issues. *See, e.g.*, *Nash v. United States*, 398 U.S. 1 (1970) (Supreme Court resolution of circuit court conflict as to the proper method of treating bad debt reserves on the transfer of accounts receivable in an I.R.C. § 351 exchange); *In re Munter*, 63 T.C. 663 (1975) (unresolved question whether the tax benefit rule applies to I.R.C. § 336).

The rule also has been described as one of "inclusion and exclusion: recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded*." *Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979) (emphasis in original), *cited in* *Home Mut. Ins. Co. v. Commissioner*, 639 F.2d 333, 650 n.1 (7th Cir. 1980) (en banc).

For recent articles discussing the tax benefit rule, *see, e.g.*, Bishop, *The Tax Benefit Rule After Unvert: Does it Compromise The Statute of Limitations*, 51 J. TAX. 272 (1979); Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. REV. 265 (1978); Note, *Scope of Tax Benefit Rule Limited*, 32 U. MIAMI L. REV. 487 (1977).

173. 639 F.2d 349 (7th Cir. 1980) (per curiam), *aff'g* 639 F.2d 333 (7th Cir. 1980).

174. *Id.* at 350. The panel decision was decided during the 1979-80 term and is discussed in detail in last year's Seventh Circuit Review: Belkin, *Taxation: Some Guidelines for Structuring Transactions*, 57 CHI. KENT L. REV. 271 (1981) [hereinafter cited as Belkin]. No further discussion of the case is presented here.

175. 641 F.2d 529 (7th Cir. 1981), *cert. granted*, 50 U.S.L.W. 3570 (Jan. 19, 1982).

176. 614 F.2d 1142 (7th Cir. 1980). This case is also discussed in detail in last year's Seventh Circuit Review. *See* Belkin, *supra* note 174, at 289-90.

ing with the custom of Illinois banks, paid the Illinois personal property tax on behalf of its shareholders.¹⁷⁷ In 1972, while the abolition of the tax was the subject of litigation,¹⁷⁸ the bank paid the tax into escrow pursuant to a statutory directive¹⁷⁹ and deducted the payments from its 1972 federal income tax return. In 1973, after the amendment abolishing the personal property tax was declared constitutional, the amounts held in escrow were refunded directly to the shareholders.¹⁸⁰ The bank did not treat the refund as a taxable event in its tax return; however, the Commissioner claimed that the refund should have been reported as income under the provisions of the tax benefit rule and section 111 of the Code.¹⁸¹ The Tax Court sustained the Commissioner's contention and the Seventh Circuit affirmed.¹⁸² The Seventh Circuit thereby continued to adhere to its interpretation of the tax benefit rule, an interpretation which has split the circuits.¹⁸³

177. Arguably these payments could be deemed a constructive dividend; however, such payments are deductible by a bank pursuant to I.R.C. § 164(e).

178. In 1970, the Illinois Constitution abolished the personal property tax as to individual taxpayers only. ILL. CONST. art. IX-A (1970) (effective Jan. 1, 1971). In 1971, the Illinois Supreme Court ruled the amendment unconstitutional as violative of equal protection. *Lake Shore Auto Parts Co. v. Korzen*, 49 Ill. 2d 137, 273 N.E.2d 592 (1971). However, the United States Supreme Court reversed, finding no violation of the equal protection clause. *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973).

179. While the litigation was pending, the Illinois legislature directed that the taxes be paid into escrow with the proviso that they be refunded if the amendment were ultimately upheld. ILL. REV. STAT. ch. 120, § 676.01 (1972) (repealed 1981).

180. The taxes were refunded to the shareholders even though the bank had actually paid them. This was held to be the proper procedure in *Lincoln Nat'l Bank v. Cullerton*, 18 Ill. App. 3d 953, 310 N.E.2d 845 (1974).

181. I.R.C. § 111(a) provides that "[g]ross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquent amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount." The recovery exclusion is defined as "the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed . . . which did not result in a reduction of the taxpayer's tax under this subtitle . . . reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section." *Id.* § 111(b)(4).

The tax benefit rule's application in these circumstances provides for the taxpayer "making up for an unwarranted deduction taken in Year One by adding to his reported income in Year Two." *Hillsboro Nat'l Bank v. Commissioner*, 641 F.2d 529, 531 n.1 (7th Cir. 1981), *cert. granted*, 50 U.S.L.W. 3570 (Jan. 19, 1982). In *Hillsboro*, the unwarranted deduction was the payment of taxes which the taxpayer was *not* obligated to pay.

182. 73 T.C. 61 (1979), *aff'd*, 641 F.2d 529 (7th Cir. 1981).

183. The Seventh Circuit follows the definition of the tax benefit rule set forth in *Tennessee-Carolina Transp., Inc. v. Commissioner*, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979). This definition provides that a "recovery" of a previously deducted item occurs when there is a later event inconsistent with the deductibility of the item such as, in *Hillsboro*, abolition of the tax. *See* note 172 *supra*. The Ninth Circuit has developed its own definition of the tax benefit rule which does not follow the definition set forth in *Tennessee-Carolina*. In *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), the Ninth Circuit held that the tax benefit rule does not apply where a "recovery" does not confer any economic benefit on the entity making the recovery. Just recently, the Ninth Circuit, citing *Tennessee-Carolina*, *First Trust* and *Hillsboro* as opposite decisions, continued to adhere to its holding in *South*

The only factual difference between *Hillsboro* and *First Trust* was that in *Hillsboro* the refund check was made payable directly to shareholders, whereas in *First Trust*, the check was made payable jointly to the bank and the shareholders.¹⁸⁴ The court held that this distinction was irrelevant and that *Hillsboro* was directly controlled by *First Trust*, reasoning that in *First Trust* the bank was under a legal obligation to turn over the refunds to its shareholders.¹⁸⁵ The court, thereby properly upheld its decision from the previous session and rejected Judge Pell's call, in dissent, for the overruling of *First Trust*.¹⁸⁶ As pointed out in last year's Seventh Circuit Review, the application of the tax benefit rule in these circumstances makes eminent sense. While the net effect is that the bank has expended funds for which it has not received a deduction, it is a proper result because it has in essence paid a dividend, albeit indirectly, to its shareholders.¹⁸⁷

"Wages" vs. "Income"

In 1978, the United States Supreme Court decided in *Central Illinois Public Service Co. v. United States*¹⁸⁸ that the terms "wages" and "income" are not necessarily the same.¹⁸⁹ The Court concluded that although certain meal reimbursements given to employees constituted taxable income,¹⁹⁰ such income was not wages subject to income tax withholding.¹⁹¹ The Court noted that Congress confined the employer withholding requirement¹⁹² to wages in order to achieve simplicity and ease of administration.¹⁹³ The Court added that since "the employer is

Lake Farms. Bliss Dairy, Inc. v. United States, 645 F.2d 19, 20 (9th Cir. 1981). The Supreme Court has recently granted certiorari to both *Hillsboro* and *Bliss Dairy* and has consolidated them for review. 50 U.S.L.W. 3570 (Jan. 19, 1982).

184. 641 F.2d at 531.

185. *Id.* See note 180 *supra*.

186. The court rejected the taxpayer's argument that the facts presented by *First Trust* were different because there "the bank as joint payee, made an 'actual recovery' of the previously deducted state tax." 641 F.2d at 531. Judge Pell, in dissent, found this argument convincing, reasoning that the bank was in a position to dictate the disposition of the refunds in *First Trust*, whereas in *Hillsboro* it could not. *Id.* at 534 (Pell, J., dissenting).

187. See Belkin, *supra* note 174, at 290. The shareholders would have to report the refunds received as taxable income. I.R.C. § 61(a)(7).

188. 435 U.S. 21 (1978).

189. *Id.* at 25.

190. The company had a practice whereby it reimbursed some of its employees for lunch expenses incurred while on authorized travel. Although not before the Court, these meal reimbursements clearly were taxable income since they did not meet the requirements for exclusion set out in I.R.C. § 119 which requires that meals be furnished on the business premises of the employer and for the employer's convenience.

191. 435 U.S. at 33.

192. I.R.C. § 3402.

193. 435 U.S. at 29.

in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific congressional action, the employer's obligation to withhold be precise and not speculative."¹⁹⁴ Since there was no ruling or regulation declaring any withholding requirement for meal reimbursements or declaring such reimbursements to be wages, the Court concluded that such a withholding requirement would be an undue burden on an employer.¹⁹⁵

In *Oscar Mayer & Co. v. United States*,¹⁹⁶ the Seventh Circuit faced an extension of the *Central Illinois* issue. At issue in *Oscar Mayer* was whether compensation received by employees for personal use of company automobiles constituted "wages" for purposes of the employer withholding obligations under the Federal Insurance Contributions Act¹⁹⁷ and Federal Unemployment Tax Act.¹⁹⁸ Based on *Central Illinois*, the Service conceded that the deemed compensation was not "wages" subject to federal income tax withholding; however, it claimed that the compensation was "wages" for purposes of the FICA and FUTA taxes.¹⁹⁹

The Service claimed that the term "wages" under the withholding statutes should be given a different meaning than for FICA and FUTA purposes, asserting that *Central Illinois* did not suggest any other conclusion.²⁰⁰ The Service also relied on the FICA and FUTA regulations which provided that remuneration can be payable in a medium other than cash and still be subject to the withholding provisions.²⁰¹

The Seventh Circuit found the Service's contentions unconvincing, concluding that Congress intended the term "wages" to "be construed for FICA and FUTA purposes congruently with the manner *Central*

194. *Id.* at 31. I.R.C. § 3403 provides for employer liability for the amount of the tax required to be deducted.

195. 435 U.S. at 32. The issue of whether lunch reimbursements were ever gross income was not clearly settled until the Supreme Court issued its opinion in *Commissioner v. Kowalski*, 434 U.S. 77 (1977). The withholding requirement at issue in *Central Illinois* related to lunch reimbursements paid in 1963.

196. 623 F.2d 1223 (7th Cir. 1980).

197. I.R.C. §§ 3101-3126 [hereinafter referred to as FICA]. Employers are required to withhold FICA taxes from employees' wages pursuant to I.R.C. § 3102.

198. I.R.C. §§ 3301-3311 [hereinafter referred to as FUTA]. There is no withholding requirement under the FUTA provisions; rather, the tax is imposed directly on employers based on a certain portion of its employees' "wages."

199. 623 F.2d at 1225.

200. *Id.* at 1225-26.

201. Treas. Reg § 31.3121(a)-1(e). This regulation provides, in pertinent part: "Generally the medium in which the remuneration is paid is also immaterial. It may be paid in cash or in something other than cash, as for example, goods, lodging, food, or clothing." An almost identical regulation is also contained in the FUTA regulations. Treas. Reg § 31.3306(b)-1(e).

Illinois prescribed for the income tax provisions.”²⁰² The court strongly relied on *Royster Co. v. United States*,²⁰³ a Fourth Circuit decision, and *Hotel Conquistador, Inc. v. United States*,²⁰⁴ a Court of Claims decision.

In *Royster*, the Fourth Circuit was presented with the pre-*Central Illinois* issue of whether employee meal reimbursements were subject to income tax withholding, in addition to FICA and FUTA obligations. The court, in reaching the conclusion that they were not, analyzed the three statutes as if they were *in pari materia*.²⁰⁵ Interestingly enough, the Service in *Royster* agreed that the wording differences in the three statutes were inconsequential.²⁰⁶ In *Hotel Conquistador*, the United States Court of Claims found *Central Illinois* controlling in deciding that employee meal reimbursements were not subject to FICA and FUTA.²⁰⁷

In addition to rejecting the Service's contentions that the statutes were not *in pari materia*, and thereby agreeing with *Royster* and *Hotel Conquistador*, the Seventh Circuit also rejected the Service's reliance on FICA and FUTA regulations which provide that the medium in which remuneration is paid is immaterial.²⁰⁸ The Seventh Circuit found that the regulations relied upon by the Service were almost identical to the income tax withholding regulations.²⁰⁹ The court did note that if the Treasury were to issue regulations that “could pinpoint any

202. 623 F.2d at 1227.

203. 479 F.2d 387 (4th Cir. 1973).

204. 597 F.2d 1348 (Ct. Cl. 1979), cert. denied, 444 U.S. 1032 (1980).

205. 479 F.2d at 389-90. The Fourth Circuit, in a passage cited by the Seventh Circuit with approval in *Oscar Mayer*, stated:

Concerning FICA. 26 U.S.C. §§ 3101 and 3102 impose a tax for old age, survivors, disability and hospital benefits and require the employer to collect such taxes from the wages of the employee. § 3121(a) defines “wages” within the meaning of §§ 3101 and 3102 as “all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash.” Concerning FUTA. 26 U.S.C. § 3306(b) likewise defines “wages” as “all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash.” For the purposes of withholding income tax by the employer, 26 U.S.C. § 3401(a) defines wages: “For purposes of this chapter, the term ‘Wages’ means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash.”

Id., cited in *Oscar Mayer & Co. v. United States*, 623 F.2d at 1226.

206. 479 F.2d at 390.

207. 597 F.2d at 1352. *Hotel Conquistador* presented an almost identical issue to that in *Oscar Mayer* in that it was conceded that the federal income withholding tax was inapplicable. *Id.* at 1354. It should be noted that in Rev. Rul. 80-41, 1980-1 C.B. 211, the Service indicated that it would not follow the decision in *Hotel Conquistador*.

208. See note 201 and accompanying text *supra*.

209. Treas. Reg. § 31.3121(a)-1(e), cited in note 201 *supra*, states that the medium in which remuneration is paid is immaterial. It is identical to the following income tax withholding regulation: “generally the medium in which remuneration is paid is also immaterial. It may be paid in

differences that Congress intended for the various withholding provisions” then such regulations would be considered with some deference.²¹⁰ However, because the FICA and FUTA regulations did not contain any more specificity regarding the definition of “wages” than did the income tax withholding regulation, the Seventh Circuit held that the reasoning of *Central Illinois* was controlling and found for the plaintiff.

It was not long before the Seventh Circuit was criticized for its decision. Just two months later, the Fifth Circuit, on similar facts, came to a contrary conclusion in *Rowan Companies, Inc. v. United States*.²¹¹ In *Rowan*, the Fifth Circuit criticized the *Royster* and *Oscar Mayer* decisions, characterizing their reasoning as being based on “semantic consistency.”²¹² The Fifth Circuit instead characterized the issue as whether the Secretary’s construction of the term “wages” under the FICA and FUTA regulations was a permissible one.²¹³

The court found the regulations’ construction permissible, reasoning that federal income taxes serve a different purpose than FICA and FUTA taxes. The court further noted that liability under the FICA and FUTA statutes was primary whereas liability was secondary under the income tax withholding statute.²¹⁴ Therefore, it concluded that the statutes were not *in pari materia*.²¹⁵

The Fifth Circuit further found that *Central Illinois* was not controlling in that “ease of administration and uniformity of interpreta-

cash or something other than cash, as for example, stocks, bonds, or other forms of property.” Treas. Reg. § 31.3401(a)-1(a)(4).

210. 623 F.2d at 1227. The court added that such regulation would provide the “simplicity and certainty in the administration of the tax withholding laws” mandated in *Central Illinois* in that the employer would have notice of its withholding obligations. *Id.*

211. 624 F.2d 701 (5th Cir. 1980), *rev’d*, 452 U.S. 247 (1981). In *Rowan*, the issue was whether the value of meals and lodging provided for employees working on offshore oil rigs should be treated as “wages” for purposes of FICA and FUTA liability. Because the meals and lodging were provided for the convenience of the employer, were furnished on the business premises of the employer, and the employee was required to accept them as a condition of employment, they were excluded from gross income pursuant to I.R.C. § 119 and, therefore, not subject to federal income tax withholding. 624 F.2d at 705.

212. *Id.*

213. *Id.* at 706.

214. The court stated:

Federal income taxes are used for general expenditures. Withholding is a means to collect income taxes. FICA and FUTA taxes are collected for special purposes. They are not general revenue measures. The revenues are spent primarily to benefit the employees affected. The employer’s obligation to withhold and pay FICA taxes and to pay FUTA taxes is primary whereas its obligation under the income tax provisions is secondary. If income tax is not withheld, the tax is still a debt of the wage-earner. If FICA or FUTA are interpreted to exclude an item, no revenue is produced.

Id.

215. *Id.*

tion" were not a problem. The court noted that "most businesses today utilize computers to calculate taxes and it is a simple matter to devise a program that includes some items for one or two taxes and excludes the same items in calculating others."²¹⁶ Additionally, the Fifth Circuit felt that great deference should be given to Treasury regulations which have been in force for a long period of time.²¹⁷

Due to the conflict between the circuits, the Supreme Court granted certiorari.²¹⁸ The approach of the Seventh Circuit proved to be the proper one as the Supreme Court reversed the Fifth Circuit.²¹⁹ The Supreme Court basically followed the approach of the Seventh Circuit by following the reasoning it had put forward in *Central Illinois*. The Court went through a lengthy review of legislative history and concluded that Congress had intended to coordinate the income tax withholding system with the FICA and FUTA systems. "In both instances, Congress did so to promote simplicity and ease of administration. Contradictory interpretations of substantially identical definitions do not serve that interest."²²⁰

The Court rejected the Service's argument that Congress had implicitly approved the 1940 FICA and FUTA Treasury regulations when it reenacted the FICA and FUTA taxes in the 1954 Code, and that Congress had thereby approved two different definitions of the term "wages." The 1940 regulations, which were almost identical to the present regulations, eliminated the convenience-of-the-employer rule for purposes of the computation of wages under FICA and FUTA, a rule which establishes inclusion or exclusion from gross income.²²¹ By eliminating a rule which limits the scope of wages for income tax withholding purposes, the Treasury Department thereby created a distinction between "wages" for FICA and FUTA purposes and for income tax withholding purposes. The Court found that the Treasury regulations were applied in such an inconsistent manner that one could not conclude that Congress had intended to endorse different interpretations of the term "wages" when it enacted the 1954 Code.²²² Because

216. *Id.* at 706-07.

217. *Id.* at 706.

218. 449 U.S. 1109 (1981).

219. 452 U.S. 247 (1981).

220. *Id.* at 257.

221. The convenience-of-the-employer rule is the rule contained in I.R.C. § 119 which must be met before meals or lodging provided to an employee may be excluded from his gross income. See note 190 *supra*.

222. The Court went through a lengthy review of how the regulations were once amended and that the rulings issued by the Commissioner were inconsistent and subject to many changes. 452 U.S. at 258-62.

the Treasury regulations failed to implement the definition of "wages" in the manner intended by Congress, the Court declared them to be invalid.²²³

The Supreme Court finally has brought some order to a hotly contested and confused area. As a result, the Service is finally drafting new regulations which hopefully will define "wages" in a consistent manner for FICA, FUTA and income tax withholding purposes.²²⁴ In the short run, however, there probably will be additional litigation when taxpayers run to seek refunds of FICA and FUTA taxes which were paid on nontaxable items.²²⁵

CONCLUSION

The 1980-81 term of the Seventh Circuit was a relatively quiet one in the tax area; however, the court's performance should be characterized as quite noteworthy. In *Redding*, the court finally held what many

223. *Id.* at 262-63. It should be noted that after the Supreme Court decision in *Central Illinois*, but before *Rowan*, the Service issued Rev. Proc. 80-53, 1980-2 C.B. 848, setting forth the procedures it would follow in response to *Central Illinois*. The Service stated that certain taxable fringe benefits would not be treated as "wages" for withholding tax purposes where:

- (1) The payments are not the type of benefit treated as wages under the statute, a regulation, a revenue ruling, a revenue procedure, or a court decision; and
- (2) There is a reasonable basis for the belief that such benefits cannot be considered as remuneration for services.

This revenue procedure was not brought up in *Rowan* because the Service was attempting to characterize an item of income that was not "wages" for withholding tax purposes as "wages" for FICA and FUTA purposes.

224. See TAX MNGM'T (BNA) 81-16, at 15 (Aug. 10, 1981).

225. Such additional litigation may be limited. In December 1981, the Service issued procedures for employers claiming FICA and FUTA refunds as a result of the *Rowan* decision. Rev. Proc. 81-69, 1981-52 I.R.B. 26; Rev. Rul. 81-310, 1981-52 I.R.B. 13. Revenue Procedure 81-69 details the procedures to be followed and the forms to be filed. Revenue Ruling 81-310 addresses refunds of FICA where either the employee has consented to his portion of the refund being paid to the employer or the employee has failed to respond to a consent request.

IRS Commissioner Roscoe Egger estimated that the number of tax returns claiming such refunds may exceed two million with over two billion dollars being sought. STAND. FED. TAX REP. (CCH) ¶ 6887 (1981).

The Service has also issued procedural guidelines for its agents to use in assessing whether employment tax cases should be conceded or contested. According to the Service, the following cases should not be contested:

1. Cases of meal allowances or reimbursements, whether or not deductible by the employee as a trade or business expense;
2. Cases involving meals and lodging that were provided for the convenience of the employer;
3. Cases involving meal allowances or reimbursements of expenses incurred by the employee as business expenses; and
4. Any other case involving benefits, allowances or reimbursements of expenses incurred in the business of the employer, which are not deductible as a trade or business expense of the employee. This applies only to the situation where there is no published authority making clear that the item in question is a wage and there is a reasonable belief that the item is not remuneration for services.

STAND. FED. TAX REP. (CCH) ¶ 8138 (1981) (Rewrite Bulletin).

had long suspected: the holding of *Palmer v. Commissioner* that a corporation's grant to shareholders of rights to purchase its property cannot constitute a dividend because the mere grant of rights does not diminish the corporation's assets is no longer good law. It should not be long before the Seventh Circuit is upheld on this correct position. The Seventh Circuit was upheld by the Supreme Court on its controversial holding in *Oscar Mayer* that "wages" for FICA, FUTA and income tax withholding purposes must be defined in a consistent manner.

Finally, on the lighter side, the Seventh Circuit was, once again, correct in *Birkenstock v. Commissioner*.²²⁶ In *Birkenstock*, the taxpayers presented the age old argument that they were entitled to reduce their gross income to its gold value for tax reporting purposes. Like many of its predecessors, the Seventh Circuit invoked the golden rule that the measure of taxable income is in dollars.²²⁷

226. 646 F.2d 1185 (7th Cir. 1981). The decision originally was unreported. The court undoubtedly decided to publish the opinion because of the frequency with which this issue arises.

227. For a sample of other taxpayers who have unsuccessfully raised this argument, see the list of cases at 646 F.2d at 1186.