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TAXATION: SUBSTANCE v. FORM AND OTHER ESOTERICA

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In the 1984-85 term,¹ the United States Court of Appeals for the Seventh Circuit decided several significant tax cases. In doing so, the circuit did not hesitate to march to the beat of a different drummer. This article will discuss a taxpayer's inability to successfully argue the form of a tax shelter over its substance;² but a taxpayer's success in arguing substance over form with respect to investment tax credit;³ the tax preparer's duty to inquire into taxpayer supplied information;⁴ the non-deductibility of certain business meal expenses;⁵ the new test with respect to whether capital is a material income producing factor;⁶ the excludability of certain bonds from estate taxation;⁷ the validity of the income forecast method of depreciation for motion pictures;⁸ and the valuation of players' contracts in sports franchises.⁹

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1. This article discusses tax cases decided by the Seventh Circuit between July 1, 1984 and June 30, 1985.

2. *Saviano v. Commissioner*, 765 F.2d 643 (7th Cir. 1985). See *infra* notes 10 to 37 and accompanying text.

3. *Comdisco, Inc. v. United States*, 756 F.2d 569 (7th Cir. 1985). See *infra* notes 38 to 66 and accompanying text.

4. *Brockhouse v. United States*, 749 F.2d 1248 (7th Cir. 1984). See *infra* notes 67 to 111 and accompanying text.

5. *Moss v. Commissioner*, 758 F.2d 211 (7th Cir.), cert. denied, 106 S. Ct. 382 (1985). See *infra* notes 112 to 134 and accompanying text.

6. *Van Kalker v. Commissioner*, 54 A.F.T.R.2d ¶ 5671 (P-H), 84-2 U.S. Tax Cas. ¶ 9727 (CCH) (7th Cir. 1984). See *infra* notes 135 to 152 and accompanying text.

7. *Haffner v. United States*, 757 F.2d 920 (7th Cir. 1985). See *infra* notes 153 to 177 and accompanying text.

8. *Gordon v. Commissioner*, 766 F.2d 293 (7th Cir. 1985). See *infra* notes 178 to 189 and accompanying text.

9. *Selig v. United States*, 740 F.2d 572 (7th Cir. 1984). See *infra* notes 190 to 206 and accompanying text.

COMMERCIAL SURREALISM

In *Tufts v. Commissioner*,¹⁰ the Supreme Court held that on a taxpayer's disposition of property encumbered by nonrecourse indebtedness that exceeds the fair market value of the property, the amount which the taxpayer realizes is equal to the unpaid balance of the debt.¹¹ The Court predicated its holding on a tax benefit theory.¹² Unless the amount of the mortgage is deemed to be realized, the taxpayer would have received untaxed income at the time the loan was extended, would have been entitled to increase his basis in the property for depreciation purposes by the amount of the indebtedness¹³ and would avoid taxation upon extinguishment of the obligation. The Court's analysis was based on two fundamental rules. First, loan proceeds do not qualify as income to a taxpayer because he incurs an obligation to repay that loan at some date. If the borrower is relieved of the liability to repay, the loan proceeds will be includible in his income as if he received cash to satisfy the obligation.¹⁴ Second, the recovery within a taxable year of a previously deducted item must be included in gross income to the extent that it produced a tax benefit in a previous year.¹⁵ Deductions for depreciation provide shelter from tax. A taxpayer's basis in his property is reduced by the amount of such deductions, and the taxpayer must realize an increased gain or decreased loss on his disposition of the property.¹⁶ For purposes of these rules, the *Tufts* court thought it irrelevant that the amount of the nonrecourse loan exceeds the fair market value of the property. Although in that situation, the taxpayer, against whom the lender has no personal recourse, may have no economic motivation to continue mortgage payments, the Supreme Court assumed that the mortgage will be repaid in full.¹⁷

In *Saviano v. Commissioner*,¹⁸ the Seventh Circuit for the first time confronted a taxpayer's argument that the *Tufts* decision mandates that a nonrecourse loan secured by a percentage of the proceeds of a mining venture be treated as a true loan even if there does not exist "a reasonable likelihood that the loan will be repaid in light of all reasonably foresee-

10. *Commissioner v. Tufts*, 461 U.S. 300, *reh'g. denied*, 463 U.S. 1215 (1983).

11. 461 U.S. at 317-18.

12. *Id.* at 307-14.

13. *Id.* at 312-14.

14. *Id.* at 312-14; I.R.C. § 1001 (1985).

15. 461 U.S. at 308-10.

16. I.R.C. § 1014(b).

17. 461 U.S. 300.

18. 765 F.2d 643 (7th Cir. 1985).

able risks.”¹⁹ The taxpayer’s argument supposed that the *Tufts* holding applies to all nonrecourse loans and mandates a tax benefit analysis. The Seventh Circuit, presented with the issue of whether an expense is deductible when paid with the proceeds of a nonrecourse loan which may not be repaid, refused to apply the *Tufts* analysis. Rather, it used an economic analysis in order to rule that the essence of the relationship between the taxpayer and the lender was that of co-venturers and, accordingly, that the loan proceeds were in the nature of an equity investment by the lender. Thus, expenses paid with the loan proceeds were not deductible by the borrower as a mining expense.²⁰

The *Saviano* case concerned two separate tax shelters promoted by International Monetary Exchange (IME) in 1978 and 1979. The case was before the court on appeal from the Tax Court’s partial summary judgment in favor of the IRS, and the court assumed that the various steps of the transaction were consummated in the manner set forth in the offering materials.²¹ In the 1978 transaction, IME ostensibly obtained for Saviano a mineral lease on certain gold-bearing land in Panama which Saviano would develop. Saviano would thereby obtain deductions for mining development expenses under I.R.C. § 616(a).²² In order to obtain a deduction of \$40,000 in 1978, Saviano deposited \$10,000 with IME.²³ He also entered into a “Loan Agreement” with IME under which he purportedly borrowed \$30,000 from IME under a nonrecourse obligation bearing interest at 10% and which would be payable and secured solely by the proceeds resulting from the mineral claim or any minerals extracted therefrom.²⁴ Any interest on the note unpaid when due was to be treated as a new advance under the loan agreement. In addition to interest, IME was also entitled to a commission of two percent of the net amount of any sales made from the claim. Under the terms of the Loan Agreement, IME’s only self-help was a provision that, if the full advances under the loan equalled the estimated market value of the gold, IME could extract and liquidate sufficient gold to reduce the

19. *Gibson Prod. Co. v. United States*, 637 F.2d 1041, 1047 (5th Cir. 1981).

20. 765 F.2d at 650.

21. *Id.* at 645.

22. Under the at-risk rules of I.R.C. § 465 added by the Tax Reform Act of 1976 the amount of taxable losses incurred in business or investment ventures cannot exceed the amount of taxpayer’s economic commitment to the business or venture. In 1978, those provisions were extended to I.R.C. § 616(a) mining expenses to disallow such deductions to the extent the mining activities were financed through nonrecourse indebtedness as opposed to the taxpayer’s actual cash outlay. The adoption of the 1978 amendment to I.R.C. § 465 forced the IME to restructure its tax structure program for the 1979 taxable year.

23. 765 F.2d at 645.

24. *Id.* at 646.

indebtedness to an amount equivalent to 75% of the estimated market value.²⁵ Saviano was not required to pay anything to obtain the lease.²⁶ Although the lessor was entitled to fifty percent of the extracted gold, after deductions for certain expenses, the loan did not require Saviano to ever extract gold.²⁷ The lease would terminate on the earlier of April, 1990 or Saviano's abandonment of the mining operation.

The Tax Court²⁸ held for the Internal Revenue Service on the ground that an expense is deductible by a cash basis taxpayer only in the year in which payment is made²⁹ or in which the taxpayer incurs a definite obligation to make payment.³⁰ That is the time when the taxpayer suffers an economic detriment. Since the obligation to IME was contingent upon the sale of gold, Saviano would not suffer an economic detriment until the loan is actually paid, if ever.³¹

In the 1979 tax shelter scheme, the taxpayer deposited \$8,000 with IME.³² The taxpayer received a mineral claim. He then sold IME an option to purchase gold extracted from the claim for \$32,000.³³ IME, acting as the taxpayer's agent, paid \$40,000 to prepare the claim for the extraction of gold.³⁴ The taxpayer claimed the entire amount of this payment as a deduction on his 1979 tax return. The Service asserted that the taxpayer's deduction should be denied to the extent of the \$32,000 obtained from IME from the sale of the option and also that the option proceeds should be taxed as income to the taxpayer in 1979. The Tax Court, in granting the Service a partial summary judgment, ruled that the \$32,000 payment to the taxpayer was includible in the taxpayer's income for 1979, on the theory that the option was not a true option but rather a right of first refusal. On appeal, the Seventh Circuit affirmed the decision of the Tax Court.

The taxpayer, in his arguments to the Seventh Circuit, attempted to characterize the sale of his option as an "open transaction."³⁵ The Seventh Circuit deftly swept this argument aside concluding that since the taxpayer had no basis in the mineral claims, none of the money received from IME could be classified as a return of capital. Furthermore, since

25. *Id.*

26. *Id.* at 645.

27. *Id.*

28. 80 T.C. 955 (1983).

29. *Id.* at 965.

30. *Id.*

31. *Id.*

32. 765 F.2d at 651.

33. *Id.*

34. *Id.*

35. *Id.* at 652.

the gain recognizable as a consequence of the sale of the option was ordinary income, there was no rationale for applying the "open transaction" rule to defer the recognition of income from the transaction to a subsequent tax year.

The Seventh Circuit, in *Saviano*, effectively applies an economic analysis approach to the evaluation of the tax effect of a nonrecourse loan. The decision demonstrates that the economic analysis and the tax benefit analysis are not mutually exclusive.³⁶ Courts can pick and choose the theory best suited to the circumstances to strike at abusive tax shelters.³⁷ *Saviano* reflects the inclination of the court to examine the substance of a tax shelter scheme and disregard, when appropriate, the form in which such transaction is cast by the taxpayer.

INVESTMENT TAX CREDIT: SUBSTANCE OVER FORM

In *Comdisco, Inc. v. United States*,³⁸ the Seventh Circuit held that a taxpayer could disavow the form of a transaction and argue its substance if there is no possibility of a conflicting claim to the tax benefit. Specifically, Comdisco leased property from a lessor. The lessor had an existing lease on the property with another lessee. The lessor assigned its rights in the latter lease to Comdisco. Thus, in effect, Comdisco became a lessee-sublessor. Such a relationship made Comdisco eligible for the investment tax credit³⁹ (hereinafter ITC) under I.R.C. § 48(d)(1)⁴⁰, treat-

36. Indeed in Footnote 5 in *Tufts*, 461 U.S. at 307-08, the Supreme Court indicates that the Commissioner might have argued that a nonrecourse mortgage is not a true debt, but is a joint investment between a mortgagor and mortgagee.

37. The Seventh Circuit had no doubt that IME has packaged an abusive shelter. They freely noted "that only a fool would actually believe that the transactions did in fact occur as described. The many elements of commercial surrealism present in these tax shelters should have put a reasonable person on notice that he was not being shown all the cards in the deck." 765 F.2d at 654.

38. 756 F.2d 569 (7th Cir. 1985).

39. I.R.C. § 38(a) (1985) provides:

(a) *Allowance of credit.*—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—(1) the business credit carryforwards carried to such taxable year, (2) the amount of the current year business credit, plus (3) the business credit carrybacks carried to such taxable year.

Id. The business credit includes the 10% regular percentage investment tax credit. I.R.C. §§ 38(b)(1), 46(a)-(b).

40. I.R.C. § 48(d) (1985) provides in part as follows:

(d) *Certain leased property.*—(1) *General Rule.*—A person (other than a person referred to in section 46(d)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat the lessee as having acquired such property (3) *Limitations.*—The elections provided by paragraphs (1) and (2) may be made with respect to property which would be new section 38 property if acquired by the lessee

Id. at ¶¶ (1), (3).

Treas. Reg. § 1.48-4(a)(1)(iii) (1984) provides that the lessee be the "original user" to qualify for

ing Comdisco as having acquired the property as lessee. The court concluded that section 48(d)(1) entitled Comdisco to the ITC and reversed the district court's decision.⁴¹

Comdisco arranged leases on new and used computer equipment. In 1974, Comdisco arranged the following transactions with Decimus⁴² and a third party: (1) Decimus leased computer equipment to a third party,⁴³ (2) Decimus assigned to Comdisco all rights and duties under the Decimus/third party lease, (3) Decimus leased the same equipment [from (1)] to Comdisco.⁴⁴ Comdisco and Decimus structured the transaction in this manner so that Decimus could comply with Regulation Y pertaining to banks and bank holding companies.⁴⁵ Decimus, as a subsidiary of a bank holding company, was subject to Regulation Y's provisions regarding rate of return on personal property leases. A direct lease to the third party would not have had the requisite return.⁴⁶ Because the Decimus/Comdisco lease contained a longer leasehold than the Decimus/third party lease, the former fell within Regulation Y.⁴⁷ After the lease with the third party expired, the equipment reverted back to Comdisco. Comdisco, however, never entered into a formal sublease with the third party. If Comdisco was in form and substance a lessee-sublessor, the ITC would be undisputedly available.⁴⁸ As a lessee in the Decimus/Comdisco lease, and in effect a sublessor to the third party, Comdisco claimed the ITC.⁴⁹

On appeal, the Seventh Circuit first concluded that Comdisco in

the credit. *See also* Treas. Reg. § 1.48-2(b)(7) (1984) (a use by the lessor or some other person not for the property's intended function is not an original use and, thus, does not preclude ITC).

41. 756 F.2d at 579.

42. *Id.* at 573. Decimus Computer Leasing Corporation also arranged leases. Decimus, as a subsidiary of a bank holding company, was subject to Regulation Y (*see infra* notes 45-47 and accompanying text). Decimus and Comdisco entered into three similar series of transactions. *Id.* at 573-74. For simplicity, only one series will be discussed.

43. The Decimus/third party lease provided for rental at \$73,381 per month for forty-eight months, with Decimus retaining the ITC and retaining the "right to assign the leases 'to a third party, said third party [Comdisco] to become Lessor's primary lessee for the equipment under another lease.'" 756 F.2d at 573.

44. The Decimus/Comdisco lease provided for rental at \$73,381 per month for sixty months, authorized Comdisco to sublease the equipment to the third party, and transferred the ITC to Comdisco. *Id.* at 573-74.

45. *See* 12 C.F.R. § 225.25(b)(5) (1985).

46. 756 F.2d at 573-74. Regulation Y requires a certain return on leased property by bank holding company subsidiaries. 12 C.F.R. § 225.25(b)(5)(iv) (1985) provides that the lease "will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease. . . ."

47. The "cost of financing" factors include the term of the lease. 12 C.F.R. § 225.25(b)(5)(iv) at n.5. In the series of transactions not discussed, the Decimus/Comdisco lease provided for a higher rent instead of a longer term. 756 F.2d at 574.

48. 756 F.2d at 577.

49. *Id.* at 574.

economic reality created a lease-sublease.⁵⁰ The Government argued that the Decimus/Comdisco lease was a sham because the third party made the lease payments directly to Decimus and Comdisco never possessed the equipment. The court rejected these arguments on the basis that the third party's direct rental payments and Decimus' direct delivery to the third party were necessitated by "transactional efficiencies" and "business realities."⁵¹ Indeed, Comdisco was a lessee-sublessor. After the expiration of the lease with the third party, the equipment reverted to Comdisco.⁵² In addition, the court noted that if Comdisco was not, in reality, a lessee-sublessor in the transaction, the Decimus/third party lease would be unenforceable as contradictory to Federal Regulation Y.⁵³

After noting the economic reality of the lease-sublease, the court concluded that Congressional purpose would be served by allowing Comdisco to take the ITC.⁵⁴ Congress intended that the credit be liberally construed so as to stimulate the country's economic growth.⁵⁵ Without Comdisco, Decimus could never have entered into the transaction. Thus, Comdisco was the party "actually generating the demand for the investment" and was, therefore, entitled to the credit.⁵⁶

Generally, although the Internal Revenue Service may attack the substance over the form of a transaction,⁵⁷ a taxpayer may not disavow the form chosen for the transaction.⁵⁸ Thus, the rule would preclude Comdisco from arguing a lessee-sublessor relationship when the form of the transaction created a lessee-lessor's assignee status.⁵⁹ However, the rule, the court noted, created an unfair relationship between the taxpayer and the IRS.⁶⁰ In order to alleviate this unfair treatment, the Seventh Circuit concluded that the general rule need only apply in cases which

50. *Id.* at 577.

51. *Id.* at 576.

52. *Id.* Moreover, in the other series of transactions, Comdisco paid Decimus monthly for incremental rent for the difference between the Decimus/Comdisco lease and the Decimus/third party lease.

53. *Id.* at 576-77. Here, the court noted that experienced business people would not have entered into an unenforceable contract. Thus, the parties intended a lessee-sublessor relationship.

54. *Id.* at 577.

55. S. REP. No. 1881, 87th Cong., 2d Sess. (1962).

56. H. R. REP. No. 1477, 87th Cong., 2d Sess. (1962).

57. *See, e.g., Sullivan v. United States*, 618 F.2d 1001, 1007 (3d Cir. 1980) (noting that the Commissioner may attack substance over form).

58. *See, e.g., Commissioner v. National Alfalfa Dehydrating*, 417 U.S. 134, 149 (1974) ("This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless once having done so, he must accept the tax consequences of his choice . . .").

59. 756 F.2d at 577.

60. *Id.* at 577-78. Furthermore, the court noted that the Fifth Circuit disagreed in *Spector v. Commissioner*, 641 F.2d 376, 386 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981) ("The parties are free to make their own agreement. The Commissioner, on the other hand, has to deal with the apparent agreement he is faced with. It does not seem unfair that he should be less strictly bound to its bona

two parties in a transaction could each claim a tax benefit to which only one party is entitled. One party argues form; the other argues substance. Although only one party is entitled to the benefit, the IRS would have to proceed against both.⁶¹ In the ITC leasing context, however, either the lessor takes the credit or, upon an I.R.C. § 48(d)(1) express election, the lessee takes it.⁶² Thus, because there was no possibility of conflicting claims the court concluded that Comdisco was entitled to the ITC.⁶³

The *Comdisco* case impacts on the ability of a taxpayer to disavow form and argue substance to the IRS. The taxpayer, however, must meet two criteria: (1) there must be no other party who could possibly use the form to argue a conflicting tax benefit,⁶⁴ and (2) the taxpayer must consistently characterize the transaction by its substance.⁶⁵ In the ITC context, the former criterion will always be met—only one party could take the credit. The credit can be transferred only by express election. The court, however, did not address the question of whether the taxpayer may argue substance if all possible conflicting claimants waive the right to the beneficial tax treatment. Arguably, the Seventh Circuit will allow a taxpayer to argue substance over form, after such a waiver, because there would be no possibility that the IRS would have to proceed against more than one taxpayer. After a waiver is obtained, there would be no purpose in applying the general rule.⁶⁶

TAX RETURN PREPARER'S DUTY TO INQUIRE

In *Brockhouse v. United States*,⁶⁷ a case of first impression, the Sev-

rides than are the parties themselves . . ." quoting *Harvey Radio Laboratories, Inc. v. Commissioner*, 470 F.2d 118, 120 (1st Cir. 1972)).

61. *Id.* at 577-78. Thus, the IRS would have to take action against both parties to determine which one should get the beneficial tax treatment. See, e.g., *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967).

62. See *supra* note 40.

63. In this regard the court used broad language. "We see no reason to extend the Government's power to hold a taxpayer to the technical form of its transactions to situations in which the Government will never face conflicting claims." 756 F.2d at 578. The court adopts the rule in *Weinert's Estate v. Commissioner*, 294 F.2d 750 (5th Cir. 1961) ("The taxpayer too has a right to assert the priority of substance—at least in a case where his tax reporting and action show an honest and consistent respect for the substance of the transaction." 294 F.2d at 755). 756 F.2d at 578. *Comdisco* had acted as if it was a lessee-sublessor during the transactions. Additionally, the court summarily dismissed the "original user" argument noting that because *Comdisco* was the lessee, it also was the "original user" (see *supra* note 40). See, e.g., *Illinois Valley Paving Co. v. Commissioner*, 687 F.2d 1043 (7th Cir. 1982) (per curiam) (holding that a leasing is an original use). 756 F.2d at 579.

64. See *supra* note 63.

65. *Id.*

66. *Id.*

67. 749 F.2d 1248 (7th Cir. 1984).

enth Circuit held that a tax return preparer⁶⁸ is liable under Internal Revenue Code section 6694(a)⁶⁹ for failing to inquire into the sufficiency and credibility of taxpayer-supplied information when such failure results in filing a return that violates a rule or regulation.⁷⁰ This holding creates a duty on tax return preparers to inquire into unverified information supplied by taxpayers.

In 1976, Congress enacted section 6694(a)⁷¹ providing for preparer penalties upon any “negligent or intentional disregard of rules and regulations.”⁷² Treasury Regulations promulgated under that section provide that a preparer will not be liable if the preparer “exercises due diligence” in applying the rules and regulations.⁷³ However, the Treasury did not address the question whether a preparer may rely on unverified information supplied by the taxpayer.⁷⁴

The Internal Revenue Service attempted to answer this question in Revenue Procedure 80-40⁷⁵ which sets forth guidelines in applying the statute. In applying section 6694(a), the Service will look at the facts and circumstances of the particular case, including the: (1) Nature of the Error—was the error the result of a complex or uncommon rule which a competent preparer may have missed?; (2) Frequency of Errors—was the error isolated or repeated, was it obvious, or was it flagrant?; and (3) Materiality of Error—was the error immaterial in relation to the taxpayer’s

68. I.R.C. § 7701(a)(36) (1985) (defining a tax return preparer as any person or employer of such a person who prepares returns for compensation).

69. I.R.C. § 6694(a) (1985) which provides:

Negligent or intentional disregard of rules or regulations.—If any part of any understatement of liability with respect to any return or claim for refund is due to the negligent or intentional disregard of rules and regulations by any person who is an income tax return preparer with respect to such return or claim, such person shall pay a penalty of \$100 with respect to such return or claim.

70. 749 F.2d at 1251.

71. Tax Reform Act of 1976, Pub. L. No. 94-455, Title XII, § 1203(b)(1), 90 Stat. 1689 (1976).

72. I.R.C. § 6694(a) (1985).

73. Treas. Reg. § 1.6694-1(a)(1) (1985). In addition, the preparer has the burden of proof to show that he did not negligently or intentionally disregard a rule or regulation. *Id.* at ¶ (5). The regulation also provides support for the preparer if the preparer reasonably and in good faith believes that a rule or regulation does not reflect the code. *Id.* at ¶ (4).

74. Impliedly, the Treasury did not address the question because it included the following statement in subsection (b):

Willful understatement of liability: Generally, in preparing a return, the preparer may in good faith rely without verification upon information furnished by the taxpayer. To avoid the penalty, the preparer is not required to examine or review documents or other evidence in order to verify independently the taxpayer’s information. However, the preparer may not ignore the implications of information furnished. The preparer shall make reasonable inquiries if the information as furnished appears to be incorrect or incomplete.

Treas. Reg. § 1.6694-1(b)(2)(ii) (such statement was omitted from subsection (a)).

75. Rev. Proc. 80-40, 1980-2 C.B. 774. This Revenue Procedure applies only to the negligent disregard portion of § 6694(a). *Id.* at 775.

total liability?⁷⁶ If, after consideration of these factors, the Service concludes that the return was negligently prepared, it will not assess the section 6694(a) penalty if the preparer has a normal office procedure which would ensure that the error would rarely occur and that this office procedure was indeed followed.⁷⁷ Thus, the Service will allow the preparer to rely on taxpayer-furnished information and will not require the preparer to audit or examine the taxpayer's records. But, if the information appears incorrect or incomplete, the preparer must make reasonable inquiries as to the discrepancies or lack of information.⁷⁸

In Revenue Ruling 80-265,⁷⁹ the Service also attempted to answer the question of whether a preparer may rely on unverified taxpayer-supplied information. The Ruling posed two hypothetical fact situations. In Situation 1, the preparer received personal information concerning the taxpayer in addition to information regarding the taxpayer's wholly-owned corporation. None of the information disclosed that the taxpayer had made any loans to the business. In Situation 2, the information regarding the business showed that the business made interest payments to the taxpayer. In both cases, the preparer failed to include the interest income received from the business on the taxpayer's personal return. The Service held that the penalty should not be assessed in Situation 1 because the preparer had no reason to believe that the furnished information was incomplete. Conversely, in Situation 2, the penalty should be assessed because the preparer should have inquired in order to reconcile the discrepancies between the business and personal records.⁸⁰ The fact situation in *Brockhouse* falls between these two situations.

In *Brockhouse*, the appellant preparer, a certified public accountant, was assessed the section 6694(a) penalty for negligent disregard of the rules and regulations when he failed to include interest income on the taxpayer's 1978 personal return. Brockhouse prepared the taxpayer's personal return and the corporate return for the taxpayer's wholly-owned medical practice.⁸¹ In connection with the preparation, and pursuant to normal office procedure, Brockhouse sent the taxpayer a data questionnaire. The taxpayer, however, did not fill out the questionnaire, but directed the corporation's bookkeeper to send both the personal and

76. *Id.*

77. *Id.*

78. *Id.* The reasonable inquiry language closely parallels the language in Treas. Reg. § 1.6694-1(b)(2)(ii) relating to willful understatement. See *supra* note 74. Thus, the Service favors a broad interpretation of § 6694(a).

79. Rev. Rul. 80-265, 1980-2 C.B. 378.

80. *Id.*

81. 749 F.2d at 1250.

corporate returns to Brockhouse.⁸² Brockhouse used this information to prepare the returns after noting no unusual discrepancies or missing items from the prior year's returns.

The information furnished by the bookkeeper showed that the taxpayer had loaned money to the business, but that he had not received interest on the loan. The corporate information revealed, however, that the corporation paid interest, although the payee was not disclosed. The information also showed that the corporation had bank loans outstanding.⁸³ Brockhouse never inquired whether any of the interest paid was paid to the taxpayer.⁸⁴

Subsequent to the 1978 filings, the Internal Revenue Service audited the corporate return. During the audit the Service learned of the corporation's interest payment to the taxpayer⁸⁵ and assessed a section 6694(a) penalty against him. Brockhouse paid 15% of the penalty⁸⁶ and filed suit for a refund. The district court denied the refund.⁸⁷

On appeal, the Seventh Circuit affirmed the district court, holding that the section 6694(a) penalty applies when a "negligent failure to inquire into information provided by the taxpayer results in the filing of a return that violates a rule or regulation."⁸⁸ The Seventh Circuit further held that a negligent failure to inquire occurs when "the information supplied would lead a reasonable, prudent preparer to seek additional information" and the preparer does not seek such information.⁸⁹ The court concluded that, in this case, a reasonable, prudent preparer would have inquired further.

In its opinion, the court examined the Congressional purpose behind section 6694. Prior to the enactment of the Tax Reform Act of 1976, preparers were subject only to criminal fraud penalties. Because these penalties were inadequate to deter abusive practices by preparers, Congress created the section 6694 sanctions.⁹⁰ In early hearings on the bill, the sanctions were to apply only against "commercial" preparers.⁹¹

82. *Id.*

83. *Brockhouse v. United States*, 577 F. Supp. 55, 56 (1983).

84. 749 F.2d at 1250.

85. *Id.*

86. *See* I.R.C. § 6694(c) (1985).

87. 577 F. Supp. 55.

88. 749 F.2d at 1251.

89. *Id.* at 1252.

90. *Id.* at 1251. *See* H.R. REP. No. 658, 94th Cong., 2d Sess. 273-75 (1975); S. REP. No. 938, 94th Cong., 2d Sess. 349-51 (1976).

91. 799 F.2d at 1251. Congress defined "commercial" preparers as "individuals often without formal training engaged in the seasonal business of preparing tax returns." H.R. REP. No. 658, 94th Cong., 2d Sess. 274 (1975).

However, Congress decided that, with the enormous increase in professional and commercial return preparation in the years prior to 1976, the sanctions should apply against all negligent preparers as a means of regulation.⁹² Applying the penalty to such a failure to inquire appears to fall within Congressional intent.

The court relied upon legislative history, Treasury Regulations, and IRS Rulings in creating the reasonable, prudent preparer standard of care. Congress intended that the section 6694(a) penalties should be interpreted in a manner similar to the taxpayer penalties in I.R.C. § 6653(a).⁹³ The "reasonable person under the circumstances" standard—"what a reasonable and ordinarily prudent person would do under the circumstances"—used in the taxpayer penalty setting was, therefore, applicable to tax preparer penalties.⁹⁴ Moreover, the Treasury Regulations require due diligence,⁹⁵ similar to the reasonable preparer's response, and impliedly require an inquiry into taxpayer-supplied information.⁹⁶ Finally, the court noted that the Service creates a duty to inquire when there is reason to believe that the information furnished is incomplete.⁹⁷ Thus, Congress, the Treasury, and the Service appear to support the court's standard of care.

The court then determined that Brockhouse had not met this duty. Because Brockhouse knew that there were loans from the taxpayer to his business and that the business paid interest, the fact that interest *might* have been paid to the taxpayer was relatively apparent. Interest bearing loans in this situation are not uncommon.⁹⁸ The error could have been discovered with minimal effort. Therefore, the court concluded that the reasonable, prudent preparer would have inquired into whether the taxpayer received any interest.

Judge Campbell submitted a long and vehement dissent.⁹⁹ He ar-

92. 749 F.2d at 1251. See H.R. REP. No. 658, 94th Cong., 2d Sess. 275 (1975); S. REP. No. 938, 94th Cong., 2d Sess. 351 (1976). Arguably, by regulating all preparers, Congress intended to curb all preparer practices which result in less tax revenues. This is a departure from the "abusive" practices by "commercial" preparers originally targeted by Congress. H.R. REP. No. 658, 94th Cong., 2d Sess. 275 (1975) (In these "abusive" situations the preparer, after promising a certain minimum refund, would require the taxpayer to sign the return in blank and then claim fictitious deductions or excess exemptions).

93. H.R. REP. No. 658, 94th Cong., 2d Sess. 278 (1975).

94. See *Marcello v. Commissioner*, 380 F.2d 499 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968). The Fifth Circuit applied the "lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances" standard. 380 F.2d at 506.

95. Treas. Reg. § 1.6694-1(a)(1) (1985).

96. Treas. Reg. § 1.6694-1(b)(2)(ii) (1985). Cf. *supra* note 74.

97. Rev. Rul. 80-265, 1980-2 C.B. 378.

98. 749 F.2d 1252; cf. 749 F.2d 1253 (Campbell, J., dissenting) (a noninterest bearing loan is the common scenario).

99. 749 F.2d at 1253-56 (Campbell, J., dissenting).

gued that, as a penal statute, section 6694(a) should be strictly construed. Thus, because the Internal Revenue Code expressly bans “negligent . . . disregard of rules and regulations,” the penalty should be applied only when there is a misapplication of the rules or regulations.¹⁰⁰ He would not have assessed a penalty because there was no such misapplication. Brockhouse reasonably relied on information provided by the taxpayer’s experienced bookkeeper and this information fit the common practice of a taxpayer making a noninterest bearing loan to his solely-owned business.¹⁰¹

The Seventh Circuit’s liberal reading of I.R.C. § 6694(a) in *Brockhouse* imposes a duty on a tax return preparer to inquire into unverified information supplied by a taxpayer. A breach of the duty and resultant exposure to the penalty occurs when the information supplied would lead a reasonable, prudent preparer to inquire further. The Seventh Circuit limited this duty to situations where “it is simple to collect the necessary additional information.”¹⁰² This duty to inquire is consistent with the trend requiring tax practitioners to further inquire in other contexts, as when rendering tax shelter opinions.¹⁰³

This limited duty to inquire is consistent with the logical notion that a tax return preparer can never know, in fact, whether the information supplied is false or incomplete. Indeed, because the IRS has the burden of enforcing the various tax laws, the preparer need only comply with the tax laws after satisfying himself of the completeness and truthfulness of the taxpayer’s data.

The tax return preparer may avoid exposure to the section 6694(a) penalty by performing some “simple” steps which would normally lead to the disclosure of false facts and incomplete information.¹⁰⁴ The preparer should create standard office procedures for further inquiry, such as nontechnical client questionnaires.¹⁰⁵ The questionnaires should require the taxpayer’s signature as a representation that all information

100. I.R.C. § 6694(a) (1985).

101. 749 F.2d at 1255.

102. *Id.* at 1252.

103. See, e.g., Treasury Circular 230, 49 Fed. Reg. 6722 (1984) (requiring the tax practitioner to make a full due diligence inquiry into the facts upon which an advisory tax shelter opinion is based). For an extensive explanation of tax practitioners’ duties in tax shelter offerings see Falik, *Standards for Professionals Providing Tax Opinions in Tax Shelter Offerings*, 37 TAX LAWYER 4 at 701-17 (1984).

104. Such procedures are consistent with the Service’s stance not to assess the penalty in limited circumstances. See Rev. Proc. 80-40, 1980-2 C.B. 774; S. REP. No. 938, 94th Cong., 2d Sess. 357 (1975). See also *supra* notes 75-78 and accompanying text.

105. To preclude the taxpayer from applying tax laws to his transactions, questions similar to the following are appropriate: (1) Did you receive any cash or property which was not in a gift or inheritance context and not inform us as to its nature and amount? or (2) For all expenses which you

supplied is complete and truthful. If the taxpayer refuses to sign or return the questionnaire, this may be indicative of an impropriety in supplied information. In this instance, the preparer has two options: (1) withdraw from the engagement, thus risking no exposure (but losing the fees); or (2) risk some exposure while protecting one's self by performing the fluctuation tests described below.¹⁰⁶

In addition to the questionnaire, the preparer should also determine whether the current year's information fluctuates significantly with the prior year. If a significant fluctuation discrepancy is noted, the preparer should obtain and document an explanation from the taxpayer. If the explanation appears reasonable, the preparer's duty is met. If not, the preparer should examine client records. The preparer, however, is under no duty to audit the information;¹⁰⁷ he is only under a duty to perform the simple steps necessary to acquire the additional information including a reasonable attempt to obtain the prior year's return.¹⁰⁸ If, for example, the current year's charitable contributions doubled or tripled the prior year's contributions, or the current year's contributions in relation to current gross income is double such relationship from the prior year, the preparer should seek and document any and all taxpayer explanations.

One could take the position that the Seventh Circuit's liberal reading of section 6694(a) was unintended by Congress. Through enforcement of the Tax Reform Act of 1976 Congress intended to curb "abusive" practices by tax return preparers.¹⁰⁹ As an example of an intentional disregard of a rule and regulation, Congress cited the instance of a preparer deducting all of the taxpayer's medical expenses without first subtracting the applicable percentage of adjusted gross income.¹¹⁰ This example connotes a misapplication of a specific tax rule and does not imply that a preparer should be penalized for relying on unverified taxpayer supplied information. The interpretation in *Brockhouse*, however, should increase compliance with the tax laws by placing a greater burden on preparers. In addition, the *Brockhouse* majority, by qualifying the duty to cases where "it is simple to collect the necessary additional

classify as "business travel" do you have receipts and a ledger proving the amounts and nature of the transactions?

106. For a discussion of office procedures to reduce preparer exposure see *Brockhouse*, *Steps that Accountants Can Take Now to Reduce Exposure to the Return Preparer Penalties*, 26 *TAXATION FOR ACCOUNTANTS* 141 (1981). Ironically, this article was written by the preparer in the *Brockhouse* case.

107. Rev. Proc. 80-40, 1980-2 C.B. 774-75.

108. 749 F.2d at 1252.

109. See H.R. REP. No. 658, 94th Cong., 2d Sess. 274-75 (1975).

110. *Id.* at 279.

information,” has created a duty which is relatively inexpensive to meet, further helping toward increased compliance.¹¹¹

DEATH OF A PARTNER'S LUNCH EXPENSE

In *Moss v. Commissioner*,¹¹² the Seventh Circuit confronted the issue of whether a partner in an eight-member law firm could deduct his share of daily partner lunch expenses as ordinary and necessary business expenses.¹¹³ The court concluded that, although the lunch expenses were ordinary, they were not necessary business expenses.¹¹⁴ These costs constituted nondeductible personal expenses.

Appellant Moss was a partner in a small litigation firm. The firm had a huge daily caseload. Due to the caseload, the only reasonably convenient time for daily firm meetings at which members discussed cases and partners approved settlements was during lunch when the courts were closed.¹¹⁵ Consequently, the firm met daily at a nearby, reasonably priced restaurant. Moss deducted his share of partner lunch expenses, approximately four dollars per day, on his annual return.¹¹⁶ The Internal Revenue Service disallowed the deductions. The Tax Court ruled in favor of the Service,¹¹⁷ and Moss appealed the decision.

The Seventh Circuit affirmed the Tax Court's decision. The court first discussed Internal Revenue Code sections 162(a) and 262.¹¹⁸ The court observed that the problem in applying these sections was that meal expenses are simultaneously personal and business expenses.¹¹⁹ Thus, a “windfall” is created when a businessperson deducts his portion of a

111. 749 F.2d at 1252.

112. 758 F.2d 211 (7th Cir.), *cert. denied*, 106 S. Ct. 382 (1985).

113. I.R.C. § 162(a) (1985) providing: “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business”

114. 758 F.2d at 213-14.

115. *Id.* at 212.

116. *See Id.* at 211.

117. *Moss v. Commissioner*, 80 T.C. 1073 (1983), *aff'd*, 758 F.2d 211 (7th Cir. 1984), *cert. denied*, 106 S. Ct. 382 (1985).

118. 758 F.2d at 212. *See* I.R.C. § 162(a) (*supra* note 113). I.R.C. § 262 (1985) provides: “Except as otherwise provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.” *See also* Treas. Reg. § 1.262-1(b)(5) (1984) (“Except as permitted under section 162 . . . the costs of the taxpayer's meals not incurred in travelling away from home are personal expenses”).

The court noted that because Moss was a partner and not an employee, I.R.C. § 119 did not apply. 758 F.2d at 212. (I.R.C. § 119 excludes from an employee's income the value of employer provided meals when the meals are provided for the employer's convenience on the employer's premises). In addition, the court noted that I.R.C. § 162(a)(2) did not apply because Moss was not in a “travel” status. I.R.C. § 162(a)(2) allows a deduction for all ordinary and necessary business expenses incurred while travelling away from home, including meal expenses.

119. 758 F.2d at 212.

business meal.¹²⁰ The windfall is allowed in some circumstances to lighten the burden on individuals who spend more on a meal precisely *because* it is a business meal. Although the person might enjoy the meal, this deduction is allowed because his utility derived therefrom is less than his utility from the cash equivalent. This utility discrepancy is incurred by the individual because the meal may lead to a business benefit.¹²¹ This analysis spawned the Sutter Rule¹²² which is limited by current I.R.C. § 162(a)(2)¹²³ providing a deduction for the full cost of the meal when a utility discrepancy is proven.

Since, by its nature, the business meal is inherently personal, the taxpayer must prove a "real business necessity" for the meal.¹²⁴ In this regard, the court noted three significant factors: facilitation, utility discrepancy, and frequency. A business meal will be deductible when it is needed to facilitate a business discussion. The meal reduces the transaction costs in business by reducing business frictions. Taking a customer out to lunch to a more comfortable setting, for example, may ease the business discussion and quicken contract negotiations.¹²⁵ Because the cost of this type of business meal is related to income, it satisfies the business necessity requirement.

The higher the frequency of the meals, the lower their business necessity. The more often a business person and his customers eat together, the less the meal is needed for facilitating the meeting. In discussing this test, the court emphasized the frequency factor over the facilitation factor although, arguably, frequency has no relation to any income derived

120. *Id.*

121. *Id.* at 213. ("[the taxpayer] would not pay for it if it were not for the business benefit; he would get more value from using the same money to buy something else; hence the meal confers on him less utility than the cash equivalent would").

122. The Sutter Rule was enunciated in *Sutter v. Commissioner*, 21 T.C. 170 (1953):

The cost of meals, entertainment, and similar items for one's self . . . is ordinarily and by its very nature personal expenses forbidden deduction by section [262]. The presumption, no doubt rebuttable, must accordingly arise that such costs are nondeductible. . . . [W]e think the presumptive nondeductibility of personal expenses may be overcome only by clear and detailed evidence as to each instance that the expenditure in question was different from or in excess of that which would have been made for the taxpayer's personal purposes.

Id. at 173.

For a discussion of the Sutter Rule, including the applicability of the Tax Court's decision in the principal case see McNally, *Vulnerability of Entertainment and Meal Deductions Under the Sutter Rule*, 62 TAXES 184 (1984).

123. As the Court discussed in *United States v. Correll*, 389 U.S. 299, 301 n.6 (1967), the Treasury Department, because of administrative problems, requested that the deduction for meals be allowed in full—not merely the excess over a normal meal. This request was codified in I.R.C. § 162(a)(2) (creating a deduction for the full amount of the meal).

124. 758 F.2d at 213.

125. *Id.*

from the meeting.¹²⁶

The court also discussed the utility discrepancy. A utility discrepancy exists when the value of the meal to the businessperson, as a meal, is less than its cost. The court reasoned that a meal in a disagreeable restaurant or in an expensive restaurant would create such a discrepancy.¹²⁷

In applying these tests to Moss's situation, the court concluded that the meals were not needed to facilitate business, the meals were too frequent, and the meals created no utility discrepancy. The meals were not needed to facilitate the members of Moss's law firm because the firm had no more than eight lawyer/co-workers. Presumably, these members worked well together. Moreover, the fact that the firm held these lunches daily indicated the lack of business necessity for the meal. Additionally, Moss ate at a reasonably priced, agreeable restaurant. The lunch costs were approximately four dollars per day. This is about the same cost as Moss would have incurred personally. Thus, no utility discrepancy was created by these meals. The court concluded that, although the firm necessarily had to meet during the lunch hour to discuss firm business, the firm did not have to incur a deductible meal expense at this time.¹²⁸

The Seventh Circuit's holding in *Moss* impacts on those other business expenses which are also inherently personal.¹²⁹ Now, in order to deduct inherently personal business expenses, the taxpayer must show that the expense was needed to facilitate a business transaction, that the frequency of such expenses was not too high, and that the expense created a utility discrepancy in the businessperson. Moreover, the decision is not limited to law firms. The decision applies to all inherently personal business expenses regardless of the type of entity or type of business involved.

The *Moss* decision substantially relies on the frequency argument. The court blindly endorses the disallowance of lunch expenses with clients and customers when they are incurred on a daily basis: “[d]aily—

126. *Id.* Here the Seventh Circuit apparently endorses *Hankenson v. Commissioner*, 47 T.C.M. (CCH) 1567 (1984). In *Hankenson*, the Tax Court disallowed the daily deduction of lunches with clients because of the frequency of such expenses. Arguably, however, this decision may be limited to situations which the persons (these were fellow referring physicians working in the same hospital) taken out were part of a small group of clients each having many meals with the taxpayer. The expenses were not needed to facilitate any business transaction between the taxpayer and this small group of clients.

127. 758 F.2d at 213-14.

128. *Id.*

129. Examples of inherently personal expenses (where § 162(a) is overlapped by § 262) are: meals (while not in the “travel” status), entertainment, and other fringe benefits which confer a personal benefit and which are not related to income.

for a full year—is too often, perhaps even for entertainment of clients.”¹³⁰ This interpretation is not rational when, through daily lunches with many different clients, the taxpayer increases his gross income by either facilitating transactions which he may never have concluded or by easing business frictions resulting in lower costs attributable to the transaction.¹³¹ Thus, the Seventh Circuit created an inconsistent position because facilitation is related to income while frequency (although it may be a factor determining a need to facilitate) is not related to income.

More importantly, the court does not give frequency guidelines for either expenses incurred with customers or expenses incurred by firm personnel. The court holds that four or five times per week is too frequent for business lunches even when those expenses are incurred with customers.¹³² Conversely, the court appears to allow a monthly lunch deduction because it is incurred by a large business firm so that higher-level employees may become acquainted with lower-level employees.¹³³ Unfortunately, the decision gives no guidelines on how large the firm must be or, if the firm is smaller, whether monthly may be too frequent. In order to increase deductibility for those expenses that are included in the frequency “gray” areas, the other factors, facilitation and utility discrepancy, should be bolstered. In large business firms, for example, where members see very little of each other, the facilitation argument can be used to deduct meals which are incurred to promote morale and, thus, productivity. If the *Moss* criteria leave you helpless, conduct the meals on the business premises.¹³⁴

POST MORTEM IMPACT OF THE MAXIMUM TAX

*Van Kalker v. Commissioner*¹³⁵ is one of many cases which address

130. 758 F.2d at 213. See *supra* note 126.

131. This position is especially bolstered when the taxpayer takes clients to an expensive or disagreeable restaurant thereby increasing the utility discrepancy.

132. 758 F.2d at 213 (citing *Hankenson*, 47 T.C.M. (CCH) at 1569) (the Seventh Circuit may in the future hold that business meals are nondeductible when incurred daily regardless of high facilitation considerations).

133. 758 F.2d at 213. The court apparently agrees with the Tax Court in *Wells v. Commissioner*, 36 T.C.M. (CCH) 1698 (1977), *aff'd without opinion*, 626 F.2d 868 (9th Cir. 1980), *cert. denied*, 449 U.S. 1111 (1981). In *Wells*, the Tax Court disallowed lunch expenses paid by a head public defender for monthly lunch meetings with his subordinates because of his status as head public defender. The court, however, accepted the proposition that a monthly luncheon of the thirty-three public defenders would fall within § 162(a). The *Wells* court relied on facilitation of co-workers leading the members to work more productively. 36 T.C.M. (CCH) at 1699.

134. See, e.g., *McNally*, *supra* note 122. Mr. McNally recommends an executive dining room if meals are to be frequently furnished to firm members. The meals will then fall under I.R.C. § 119. In addition, the *Moss* court did not address the question of whether the cost of *Moss's* meals could be deducted as rental of the restaurant space used. 758 F.2d at 214.

135. 54 A.F.T.R.2d (P-H) ¶ 5671 (1984), 84-2 U.S. Tax Cas. (CCH) ¶ 9727 (1984).

the issue of whether capital is a material income producing factor in a taxpayer's trade or business.¹³⁶ Although the case arose in the context of the repealed maximum tax on personal service income,¹³⁷ the court's conclusion, that in certain circumstances all income derived from a business which furnishes tangible products is personal service income, impacts upon planning for family partnerships¹³⁸ and for taxpayers who have foreign earned income.¹³⁹

I.R.C. § 1348(a) imposed a fifty percent maximum tax rate on "personal service income." Section 1348(b)(1)(A) defined the term "personal service income" to include, in pertinent part, any income which is earned income within the meaning of I.R.C. § 911(b). With respect to a self-employed taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, section 911(b) provided that not more than thirty percent of the taxpayer's share of the net profits of such trade or business will be considered as earned income. Treas. Reg. § 1.1348.3(a)(3)(ii), states that capital will be a material income producing factor if a substantial portion of the gross income of the business is attributable to an investment in inventories, plant, machinery or other equipment. Capital will not be a material income producing factor where gross income primarily consists of "fees, commissions or other compensation for personal services performed by an individual. . . ."

Van Kalker custom designed, fabricated and installed wrought iron railings. In 1978, the assets used in his business consisted principally of real property, several trucks and automobiles, two metal cutters, four welders, some handmade tools and a small inventory of raw iron. The

136. See, e.g., *Gaudern v. Commissioner*, 77 T.C. 1305 (1981) (bowling supply sales); *Block v. United States*, 569 F. Supp. 981 (W.D. Tenn. 1983), *aff'd*, 732 F.2d 153 (6th Cir. 1984) (cotton brokerage); *Rubida v. Commissioner*, 460 F.2d 1172 (9th Cir. 1972) (slot machine manipulation); *Hutcheson, Jr. v. Commissioner*, 540 F. Supp. 880 (N.D. Ala. 1982) (construction contracting business); *Bruno v. Commissioner*, 71 T.C. 191 (1978) (bail bonding business).

137. I.R.C. § 1348 (1982), *repealed by*, Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(c)(1), 95 Stat. 183 (1981). There was no longer a need for a provision establishing a maximum tax rate of 50 percent on personal or service income in light of the reduction of the maximum tax rate from 70 percent to 50 percent by the Economic Recovery Tax Act of 1981.

138. See *infra* notes 149-52 and accompanying text. Banoff, Long, Steele and Smith, *Family Partnerships Capital as a Material Income-Producing Factor*, 37 TAX LAWYER 275, 278-81 (Winter, 1984) point out that neither I.R.C. § 704(e) nor the regulations thereunder explicitly incorporate by reference analogous definitions of capital as a material income producing factor, and they set forth the arguments for and against applying other statutory provisions. However, several courts dealing with family partnerships have observed that the concept of capital as a material income producing factor is found in other areas of the tax law. See *Carriage Square Inc.*, 69 T.C. 119, 130 (1977); *Bruno*, 71 T.C. at 198. Taxpayers have not been hesitant to analogize the definitions to support their position. See, e.g., *Gaudern*, 77 T.C. at 1312.

139. See *infra* notes 147-48 and accompanying text.

adjusted basis of these items was under thirteen percent of gross receipts. Cost of goods sold was twenty percent of gross receipts and the cost of labor and materials was twenty-six percent of gross receipts. Van Kalker treated the entire amount of his 1978 net income as personal service income, subject to the fifty percent maximum tax rate, on the theory that his investment in inventory and equipment was not substantial when measured against his personal skill and effort. Taking the position that I.R.C. § 1348 does not admit to a comparison of the materiality of capital relative to the materiality of personal services, and that capital was employed in the business to purchase inventory and equipment and to meet operating requirements, the IRS limited the amount eligible for the maximum tax to thirty percent of income.¹⁴⁰ The Tax Court sustained the Commissioner's position.¹⁴¹

Citing a long line of cases which found capital to be a material income producing factor where the taxpayer engaged in a business which sells a finished product unaltered by the taxpayer¹⁴² or a product altered or applied by the taxpayer,¹⁴³ the Tax Court focused on the fact that Van Kalker required capital to purchase, refine and sell a tangible product which was substantially derived from raw materials.

Writing for the Seventh Circuit, Judge Flaum rejected the Tax Court's notion that the materiality of capital automatically correlates to the production and/or sale of a tangible product. The test involves both a comparison of the amount of capital to the amount of personal services and an analysis of "whether the capital is income producing in its own right or whether its worth depends on the application of the taxpayer's personal skills."¹⁴⁴ Recognizing that there is no definite percentage ratio which would satisfy the first part of the test, the court found that Van Kalker's investment of capital was not substantial.¹⁴⁵ With respect to the second part of the test, the court relied upon *United States v. Van Dyke*¹⁴⁶ which held that capital is not a material income producing fac-

140. 54 A.F.T.R.2d (P-H) at ¶ 5672.

141. 81 T.C. 91 (1983).

142. *Moore v. Commissioner*, 71 T.C. 533 (1979) (retail grocery store); *Wilson v. Commissioner*, 43 T.C.M. (CCH) 799 (1982) (egg producing business); See *Gaudern supra*, note 136.

143. *Gullion v. Commissioner*, 43 T.C.M. (CCH) 694 (1982) (concrete flatwood business); *Rousku v. Commissioner*, 56 T.C. 548 (1971) (automobile body repair business). See *Huchinson supra*, note 136.

144. 54 A.F.T.R.2d (P-H) at ¶¶ 5673-74.

145. *Id.* at ¶ 5673. Although the court computed ratios measuring assets to gross receipts, gross income and cost of sales, and compared the results to other cases in which capital was found to be a material income producing factor, the court stated that it does not rely heavily on such comparisons because the ratios are often the product of different factors and the comparisons do not account for the different nature of businesses.

146. 696 F.2d 957 (Fed. Cir. 1982).

tor where the taxpayer specially designed and handcrafted a product. Although Van Kalker's customers purchased a product, the desirability and price of Van Kalker's ironwork was in large measure due to his artistic design, skill and effort. Thus, capital was not a material income producing factor in his business.

In *Van Kalker*, the court replaces a quantitative analysis with the more subjective approach of whether a customer would have purchased the product but for the taxpayer's skill in designing and fashioning the product. By expanding the test, the court muddies the waters with respect to the taxation of foreign earned income and income reported by partners who are members of family partnerships.

Subject to certain limitations, I.R.C. § 911(c) excludes foreign earned income from taxation. Foreign earned income is defined as income from sources within a foreign country which constitutes earned income. In the case of a self-employed individual, the rules of repealed section 911(b)¹⁴⁷ have been incorporated into section 911(d)(2)(B). According to the statute, in situations in which both personal services and capital are material income producing factors, a maximum of thirty percent of such taxpayer's share of the net profits of his trade or business in a foreign country will be considered excludable foreign earned income.¹⁴⁸ Under the *Van Kalker* test, capital will not be a material income producing factor where the skills of the taxpayer are an intrinsic part of the desirability of the product produced by his business and, in such circumstances, more than thirty percent of his foreign earned income derived from such business may avoid United States taxation.

Partnerships are frequently used by family members who contribute capital or services to conduct a trade or business. Frequently, however, family partnerships are formed to enable a high income taxpayer to spread his income among family members in a lower tax bracket and, hence, create a lower overall intra-family tax liability.¹⁴⁹ To ensure that the incidence of taxation of income derived for the employment of capital in a partnership is borne by the true owner of that capital, Congress and the Treasury have incorporated the assignment of income doctrine into

147. I.R.C. § 911(b) and (d), amended by Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 111(a), 95 Stat. 183 (1981).

148. I.R.C. § 911(d)(2)(B) (1985) provides:

In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of such trade or business, shall be considered as earned income.

149. See generally McKee, Nelson, Whitmore, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 14.01 (1977). *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119 (1977).

partnership tax law.¹⁵⁰ Thus, a person will be safely recognized as a partner for tax purposes only if capital is a material income producing factor in the partnership business, and he actually owns a capital interest in the partnership.¹⁵¹ *Van Kalker* gives the Internal Revenue Service additional ammunition to argue that a family partnership, operating a service or manufacturing business in which the end product or service is salable solely on account of the skill or efforts of one partner, is indeed a tax sham.¹⁵²

JUDICIAL SURREALISM

In *Haffner v. United States*,¹⁵³ the Seventh Circuit reviewed the issue of whether certain public housing authority obligations¹⁵⁴ (Project Notes) were subject to estate taxation. Relying on section 11(b) of the United States Housing Act of 1937 (1937 Act),¹⁵⁵ the court ruled that the Project Notes were exempt from estate taxation.¹⁵⁶

At the time of his death, the decedent owned Project Notes of an aggregate par value of \$1,085,000.¹⁵⁷ The executor of the estate filed an estate tax return listing the Project Notes on Schedule B, but stated that the Project Notes were not subject to estate taxation on the basis of section 11(b).¹⁵⁸ The Internal Revenue Service disagreed and assessed the decedent's estate \$630,808.76 in additional estate taxes.¹⁵⁹ The executor paid the additional estate tax assessment and appealed the matter to the

150. Under the assignment of income doctrine, a taxpayer cannot avoid the tax on income by assigning the right to receive the income without also transferring the property from which the right is derived. Income will be taxed to the taxpayer who earns it or creates the right to receive it. MERTONS, LAW OF FED INCOME TAX § 18.02 (1982).

151. I.R.C. § 704(e) provides:

A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

152. In *Nichols v. Commissioner*, 32 T.C. 1322 (1959), the court recognized the validity of a partnership between a radiologist and his wife, who was responsible for office services. Of course, partnership revenues were a direct function of the reputation and skill of only one partner.

153. 757 F.2d 920 (7th Cir. 1985).

154. The following public housing agency notes were the subject matter for this litigation:

- (a) \$85,000 par value Anne Arundel Co., Md., dated 4/11/78, 3.79% project notes due 4/13/79.
- (b) \$1,000,000 par Oklahoma City, Okla., dated 5/9/78, 4.12% project notes due 5/11/79.

155. 757 F.2d at 920.

156. 42 U.S.C. § 1437i(b) (1982). Section 11(b) provides in pertinent part:

Obligations, including interest thereon, issued by public housing agencies in connection with low-income housing projects shall be exempt from all taxation now or hereinafter imposed by the United States whether paid by such agencies or by the Secretary.

157. *Haffner*, 585 F. Supp. 354, 355 (N.D. Ill. 1984).

158. *Id.*

159. *Id.* at 356.

District Director of Internal Revenue. The District Director denied the appeal and the executor brought an action for refund of the additional estate tax assessment in the district court. The district court, ruling on the estate's motion for summary judgment, held that the Project Notes were not includable in the decedent's estate¹⁶⁰ and thus, not subject to estate taxation under I.R.C. § 2033.¹⁶¹ The Seventh Circuit affirmed the district court's decision, adopting the district court's opinion with only minor modifications.¹⁶²

The Seventh Circuit's decision involved the construction of the language of section 11(b) of the 1937 Act. This provision states that "[O]bligations, including interest thereon, issued by public housing agencies . . . shall be exempt from all taxation now or hereafter imposed by the United States whether paid by such agencies or by the United States." The court noted that the estate tax is not a direct tax on property, but an excise tax imposed on the passage of the value of such property from a decedent to his legatees.¹⁶³ It is well established in case law that an exemption of securities or bonds from "taxation" does not extend to an exemption from estate or inheritance taxes.¹⁶⁴ The court emphasized that such precedent should not be ignored except where Congressional intent to do so is "clear and unambiguous."¹⁶⁵

The court applied two rules of statutory construction to find that Congress intended to override prior case law addressing the issue of the exemption of property transfers from estate taxation.¹⁶⁶ The first rule provides that language of a statute should be construed giving operative

160. *Id.* at 361.

161. I.R.C. § 2033 provides: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

162. 757 F.2d at 920.

163. 585 F. Supp. at 356; *See, e.g.,* *Plummer v. Coler*, 178 U.S. 115, 130 (1900) (superseded by statute; *see American Bank & Trust Co. v. Dallas County*, 436 U.S. 855 (1983)); *Greiner v. Lewellyn*, 258 U.S. 384, 387 (1922); *United States v. Manufacturers Nat'l Bank*, 363 U.S. 194, 198 (1960).

164. *See, e.g.,* *Murdock v. Ward*, 178 U.S. 139, 145-47, 20 S. Ct. 775, 777-78, 44 L. Ed. 1009 (1900); *United States Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939); *Inglehart v. Commissioner*, 77 F.2d 704, 712 (5th Cir. 1935); *Greene v. United States*, 171 F. Supp. 459 (1959). *See also* *Treas. Reg. § 20.2033-1* (1963) which provides in pertinent part:

Various statutory provisions which exempt bonds, notes, bills, and certificates of indebtedness of the Federal Government or its agencies and the interest thereon from taxation are generally not applicable to the estate tax, since such tax is an excise tax on the transfer of property at death and is not a tax on the property transferred.

The general rule is also reflected in two cases which address the gift taxability of certain United States Treasury bills. *See Hammersley v. United States*, 16 F. Supp. 768 (Ct. Cl. 1936), *cert. denied*, 300 U.S. 659 (1937); *Phipps v. Commissioner*, 91 F.2d 627 (10th Cir.), *cert. denied.*, 302 U.S. 742 (1937).

165. 585 F. Supp. 355, 358 (1984).

166. *Id.* at 361.

effect to every clause.¹⁶⁷ The second rule provides that sections of a single statute should be presumed to have been drafted with reference to one another; the whole statute is the context for construction of any of its individual sections.¹⁶⁸

In the process of applying the rules of statutory construction, the Seventh Circuit examined two other sections of the 1937 Act.¹⁶⁹ Both of these sections addressed the tax treatment of obligations of public housing authorities. The language of section 5(e) was identical to that of section 11(b) in its reference to an exemption "from all taxation."¹⁷⁰ However, section 20(b) of the 1937 Act specifically limited the exemption from taxation by a parenthetical reference to all taxation other than surtaxes, estate, inheritance and gift taxes.¹⁷¹ The court also reviewed the legislative history of the 1937 Act, particularly certain statements made by a sponsor of the bill.¹⁷² The sponsor specifically commented that the obligations of public housing agencies, issued pursuant to the 1937 Act, "are free from income tax, surtax, estate, gift and inheritance taxes."¹⁷³ The court determined that these factors provided a sufficient basis for holding that the stated exemption from "all taxation" encompassed estate taxes.¹⁷⁴

The Seventh Circuit's technical approach to the resolution of the issue in this case was correct. However, the subject case was not an appropriate setting in which to place such heavy reliance on statutory rules of construction to override existing case law. The substantive law limiting the interpretation and effect of the phrase "exempt from all taxation" was well-established.¹⁷⁵ Neither of the parties to this action disputed this

167. *Id.* at 358. *See, e.g.,* *Adler v. Northern Hotel Co.*, 175 F.2d 619, 621 (7th Cir. 1949) (citing *Market Co. v. Hoffman* 101, U.S. 112, 115-116 (1879)); *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983).

168. 585 F. Supp. at 358. *See, e.g.,* *United States v. American Trucking Ass'n*, 310 U.S. 534, 542-44 (1940).

169. *United States Housing Act of 1937*, §§ 5(c), 20(b), *amended by*, 42 U.S.C. §§ 1405(c), 1420(b) (1946).

170. Section 5(c) of the 1937 Act reads as follows:

Obligations, including interest thereon issued by public housing agencies in connection with low-rent housing or slum clearance projects, and the income derived from such projects, shall be exempt from all taxation now or hereafter imposed by the United States.

171. Section 20(b) of the 1937 Act reads as follows: "Such obligations, shall be exempt, both as to principal and interest, from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States or by any state, county, municipality, or local taxing authority."

172. *See* 81 CONG. REC. 8086-88 (1937).

173. 81 CONG. REC. 8085 (1937).

174. 585 F. Supp. at 361. *See* *Greene v. United States*, 171 F. Supp. 459, *cert. denied*, 360 U.S. 933 (1959); *Jandorf's Estate v. Commissioner*, 171 F.2d 464 (2d Cir. 1948).

175. *Supra* note 164.

fact.¹⁷⁶ Further, in view of then existing case law, it was not necessary for the draftsmen of the 1937 Act to include a parenthetical exclusion limiting the exemption "from all taxation" in each of the provisions since the application of such case law would produce consistent tax treatment by making testamentary transfers of the referenced debt instruments subject to estate taxation. The intention of Congress to exempt the Project Notes from estate taxation was not so "clear and unambiguous," as the Seventh Circuit suggests, as to justify the court's deviation from the case law addressing the issue.

Congress prospectively limited the impact of the court's decision by enacting section 641 of the Tax Reform Act of 1984.¹⁷⁷ Section 641(a) provides that statutes exempting property from taxation shall not be interpreted as exempting such property from estate, gift and generation-skipping taxes unless it refers to the specific provisions of the Internal Revenue Code. Situations in which the executor or donor filed an estate or gift tax return reporting the transfer as subject to federal estate or gift tax, section 641(b)(2) of the Tax Reform Act of 1984 makes section 641(a) applicable to such transfers even if the transfers were made prior to the act's effective date of June 19, 1984. This provision operates to prevent claims for refunds where an estate or gift tax return was previously filed which reported the transfer as subject to Federal estate or gift tax.

INCOME FORECAST METHOD OF DEPRECIATION

In *Gordon v. Commissioner*,¹⁷⁸ the court faced the issue of whether, for purposes of the income forecast method of depreciation for a motion picture film, a cash basis taxpayer's¹⁷⁹ income from a film during a tax year includes revenues received by the distributor but not subsequently remitted by the distributor to the taxpayer.

Because motion picture and television films produce an uneven stream of income due to contract restrictions, methods of distribution and program popularity, the Commissioner recognized in Revenue Ruling 60-358,¹⁸⁰ as modified by Revenue Ruling 64-273,¹⁸¹ that the usefulness of a film for depreciation purposes may more accurately be

176. 585 F. Supp. at 356-57.

177. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.).

178. 766 F.2d 293 (7th Cir. 1985).

179. Pursuant to Treas. Reg. § 1.451-1(a) (1960), a cash basis taxpayer reports income in the year in which such income is actually or constructively received by the taxpayer.

180. 1960-2 C.B. 68.

181. 1964-2 C.B. 62.

measured by the flow of its income rather than the passage of time. Accordingly, the Commissioner authorized the use of the income forecast method of depreciation by which depreciation would be computed on the basis of a fraction, the numerator of which is the income from the film for the taxable year, and the denominator of which is the estimated total income from the film during its useful life. For purposes of the fraction, income means income from the film less the cost of distributing the film, not including depreciation.¹⁸²

Revenue Ruling 78-28¹⁸³ addressed the question whether, under the income forecast method, a cash basis taxpayer could include, as income in the numerator of the fraction, payments which the taxpayer had earned under a distribution contract but had not received by the end of the tax year. The Commissioner ruled that, since the purpose of the income forecast method is to prevent income distortion by matching depreciation deductions with income derived from assets generating the income, the numerator of the fraction used to compute the depreciation deduction for the tax year must reflect the same gross income used to compute taxable income from the film for the same period.

Mitchell Film Company was a limited partnership which owned the motion picture "Mitchell." The partners entered into an agreement with Allied Artists under which Allied distributed "Mitchell." However, no portion of the revenues from distribution for the tax year were ever remitted to the partnership.¹⁸⁴ Nonetheless, using the income forecast method of depreciation on its tax return, the partnership claimed depreciation by including the receipts reported by Allied in the numerator of the fraction.

The Seventh Circuit interpreted the term "income," for purposes of computation of depreciation by the income forecast method, to mean the income properly reportable by the taxpayer as income under its method of accounting.¹⁸⁵ Since the taxpayer received no taxable income from the film distributor for the tax year, the taxpayer was not entitled to claim a deduction for depreciation under the income forecast method.¹⁸⁶

The *Gordon* case underscores one of the principle objectives of income tax accounting, which is to match the income with the expenses incurred in the production of such income.¹⁸⁷ In order to achieve the

182. Rev. Rul. 60-358, 1960-2 C.B. at 68-69.

183. 1978-1 C.B. 61.

184. 766 F.2d at 298.

185. *Id.*

186. *Id.*

187. *Seigel v. Commissioner*, 78 T.C. 659, 693 (1982).

matching of income with expenses in the film industry, the income forecast method necessarily requires that the term "income" includes only income actually or constructively received by the taxpayer as provided by I.R.C. § 451(a) and Treas. Reg. § 1.451.1(a). The taxpayer's attempt to apply the income forecast method using the gross revenues received by the distributor but not paid to the taxpayer fails to achieve this objective since it generates depreciation deductions in the absence of corresponding taxable income. The Seventh Circuit's reliance on Revenue Ruling 78-28¹⁸⁸ and applicable case law¹⁸⁹ in deciding the Gordon case was correct and consistent with fundamental principles of income tax accounting.

COSTING OF PLAYER CONTRACTS IN SPORTS FRANCHISES

In *Selig v. United States*,¹⁹⁰ the Seventh Circuit held that the allocation of \$10.2 million of a \$10.8 million baseball franchise purchase price to the value of players' contracts was not clearly erroneous. In this regard, the court determined that the "club" market, in which players' contracts were valued in relation to the team's purchase price, was the most reasonable basis for appraisal of the players' contracts because the "club" market is a free market creating arms-length allocations.¹⁹¹

On April 1, 1970, Allan "Bud" Selig purchased the Seattle Pilots baseball team for \$10.8 million, moved the team to Milwaukee, and renamed it the Brewers.¹⁹² Using four appraisals of the Seattle team, Selig allocated \$10.2 million to the players' contracts—slightly higher than the average of the four appraisals. He allocated \$500,000 to the value of the franchise.¹⁹³ Because the players' contracts were depreciable under I.R.C. § 167(a)¹⁹⁴ and the franchise costs were not depreciable, the Internal Revenue Service challenged the allocation, valued the contracts at zero, and valued the franchise at \$10.7 million. The taxpayer sued for and obtained a refund in U.S. District Court.¹⁹⁵ The government ap-

188. 1978-1 C.B. 61.

189. *Greene v. Commissioner*, 81 T.C. 132 (1983); *Siegel v. Commissioner*, 78 T.C. 659 (1982); *Fife v. Commissioner*, 82 T.C. 1 (1984); *Wildman v. Commissioner*, 78 T.C. 943 (1982).

190. 740 F.2d 572 (7th Cir. 1984).

191. *Id.* at 578.

192. *Id.* at 575.

193. *Id.* The appraisals averaged \$1,043,000. Selig also allocated \$100,000 to equipment and supplies.

194. I.R.C. § 167(a) (1985) provides: (a) *General Rule*.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income"

195. *Selig v. United States*, 565 F. Supp. 524 (1983), *aff'd*, 740 F.2d 572 (7th Cir. 1984).

pealed this adverse ruling.

On appeal, the *Selig* court reviewed the three possible bases of valuations: the "player" market, the "free agent" market, and the "club" market.¹⁹⁶ The "player" market was the most common market in which teams negotiated to buy players' contracts. Here, however, baseball's waiver and reserve rules created price fixing not conducive to arms-length transactions.¹⁹⁷ In the "free agent" market,¹⁹⁸ players with no previous major or minor league contracts negotiated for their first contracts. Thus, this market did not include the veteran players' values which are transferred in a team sale. The "club" market included players' values in the purchase price of an entire team. These valuations involved negotiations between the buyer and seller free of baseball's regulations.¹⁹⁹ The court concluded that the "club" market was appropriate because Selig's purchase actually occurred in that market and the assigned contract values would be based on arms-length negotiations.²⁰⁰

Finally, the court noted that because Selig obtained the appraisals in the appropriate market and because his valuation approximated the appraisals, the valuation was reasonable. As additional support the court analogized *Laird v. United States*.²⁰¹ In *Laird*, the Fifth Circuit affirmed the allocation of eighty-eight percent of the purchase price of the Atlanta Falcons to football players' contracts.²⁰² Thus, the ninety-five percent allocation by Selig appeared proper.

With the participation of veteran players in the "free agent" market²⁰³ and with the limitation of players' contract values set forth in I.R.C. § 1056, this decision appears to have little current impact. Section 1056 limits the valuation of players' contracts when purchasing a sports

196. 740 F.2d at 575-76. This review was undertaken after Judge Bauer delightfully elaborated on baseball—the game and its history. The decision is enjoyable reading for any baseball fan. *Id.* at 572-74.

197. 740 F.2d at 575.

198. Veteran players had no right to declare "free agency" and compete for cash in the re-entry draft until 1976. 740 F.2d at 575-76. Thus, the "club" market conclusion (*see supra* note 191) is of little impact today. For the impact of *Selig* regarding I.R.C. § 1056 (1985) *see infra* notes 204-06 and accompanying text.

199. 740 F.2d at 576.

200. *Id.* at 578.

201. 566 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

202. *Id.* at 1237-42. In *Laird*, the purchase price of the team was first discounted by the present value of the television rights purchased. Thus, the players' contracts were valued at \$3.03 million of the \$3.5 million left after subtracting \$4.3 million of T.V. rights. *Id.* at 1230. The discount of T.V. rights is proper with respect to baseball because the purchase price of a baseball team does not include such rights. 740 F.2d at 580. *Cf.* *First Northwest Indus. v. Commissioner*, 70 T.C. 817 (1978), *rev'd and remanded on other grounds*, 649 F.2d 707 (9th Cir. 1981) (91% allocation to contracts were improper when the franchise bought was a basketball expansion team and the T.V. rights were not discounted in the allocation).

203. *See supra* note 198.

franchise to the transferor's adjusted basis of such contracts plus the gain, if any, recognized by the transferor on the transfer of such contracts. The contracts are presumed to be worth no more than one half of the franchise purchase price.²⁰⁴ The Seventh Circuit implied that this presumption was rebutted by Selig.²⁰⁵ The implication that "club" market appraisals were sufficient to rebut the presumption indicates a possible leniency by the circuit in applying the limitation, although, arguably, this leniency was unintended by Congress.²⁰⁶ Last, because professional sports teams are organized into leagues, a uniform market exists where players' contracts can be valued against one another. Other service businesses do not have such uniformity. This decision, therefore, is limited to the valuation of players' contracts for sports franchises only, and does not extend to non-sports service contracts.

204. I.R.C. § 1056 (1985) provides in part as follows:

(a) *General Rule.*—If a franchise to conduct any sports enterprise is sold or exchanged, and if, in connection with such sale or exchange, there is a transfer of a contract for the services of an athlete, the basis of such contract in the hands of the transferee shall not exceed the sum of—(1) the adjusted basis of such contract in the hands of the transferor immediately before the transfer, plus (2) the gain (if any) recognized by the transferor on the transfer of such contract (d) *Presumption as to amount allocatable to player contracts.*—In the case of any sale or exchange described in subsection (a), it shall be presumed that not more than 50 percent of the consideration is allocable to contracts for the services of athletes"

Id. at subsections (a) and (d).

205. 740 F.2d at 759 n.17:

The government argues that section [1056] nevertheless indicates the impropriety of a 95-percent allocation. The section does allow, however, for proof by a taxpayer that a specific amount exceeding 50 percent should be allowed. Congress clearly wanted to limit the tax benefits accorded to the sale of a club. But Congress's opinion on whether taxpayers in the past had allocated unreasonable amounts to player contracts does not weigh against the plaintiff here.

740 F.2d at 579 n.17.

206. Congress appears to be disenchanted with depreciating a large portion of the franchise price because a franchise tax shelter with negative tax income and positive cash flow results. See H.R. REP. 658, 94th Cong., 2d Sess. 116-17.

