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Federal Income Tax Developments: 1984

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Briner et al., Federal Income Tax Developments, 1984
FEDERAL INCOME TAX DEVELOPMENTS: 1984

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AND
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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1984 is the twelfth in a series of articles published at The University of Akron School of Law. In keeping with the established format, the scope of this survey is limited to selected substantive developments in the field of income taxation.

In preparing this article the students have authored individual articles on selected topics. Without their substantial contributions and complete dedication, this article would not have been possible. In recognition of their efforts, we wish to thank the following students:

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*Accessing Tax Accrual Workpapers
United States v. Arthur Young & Co.*

STEVEN A. DIMENGO

The status of an independent auditor's workpapers when summoned by the Service was uncertain until the Supreme Court decided *United States v. Arthur Young & Co.*¹ The major issue of the proceedings was whether tax accrual workpapers, prepared by a taxpayer's independent auditor during the course of an annual audit, were subject to disclosure to the Service pursuant to a summons under Section 7602 of the Code.² The Supreme Court reaffirmed the broad summoning power of the Service which is necessary to enforce the country's self-assessment, federal taxation system.³ Accordingly, tax accrual workpapers are required to be disclosed due to their relevance to an IRS inquiry within in the meaning of Section 7602.⁴

In *Arthur Young*, while auditing Amerada Hess Corporation's tax return, the Service directed Young to produce over a quarter of a million pages of audit workpapers, including the tax accrual workpapers accumulated in the audit of Amerada.⁵ The Service's authority for the request was Section 7602.⁶ After Young did not comply with the summons, the district court held that Young must relinquish the tax accrual workpapers to the Service.⁷ The audit program and other audit workpapers were not ordered to be disclosed because they were less relevant to the investigation of Amerada's tax returns.⁸

The appellate court found all of the audit workpapers to be relevant to Amerada's tax liability.⁹ However, the court feared the financial statements would become inaccurate due to lack of management candor if tax accrual workpapers were easily accessible. The appellate court, therefore, created an accountant work-product privilege,¹⁰ which, under these facts, prevented the Service from obtaining the tax accrual work papers due to an insufficient

¹104 S.Ct. 1495 (1984).

²I.R.C. §7602 (1982). See Note, *Internal Revenue Service Review of Tax Accrual Workpapers: United States v. Arthur Young & Co.*, 18 AKRON L. REV. 165 (1984).

³*Young*, 104 S. Ct. at 1502.

⁴*Id.* at 1501-02.

⁵*United States v. Arthur Young & Co.*, 677 F.2d 211, 215. (2d Cir. 1982).

⁶*Young*, 104 S. Ct. at 1498. Section 7602, in pertinent part, provides that the Service has the right to review any documents that may be relevant to an inquiry concerning the correctness of a person's tax liability. I.R.C. §7602.

⁷*United States v. Arthur Young & Co.*, 496 F. Supp. 1152, 1160 (S.D.N.Y. 1980).

⁸*Id.* at 1157-60.

⁹*Young*, 677 F.2d at 212.

¹⁰The privilege was modeled after the attorney work-product privilege recognized in *Hickman v. Taylor*, 329 U.S. 495 (1947).

showing of need.¹¹

The Supreme Court ruled that the Service can summon tax accrual workpapers.¹² The Court analyzed the specific wording of Section 7602 and determined that the language "may be relevant" equips the Service with a broad summoning power of items even potentially relevant.¹³ The Court rejected the policy argument concerning the potential for lack of candor between management and the auditor leading to inaccurate financial statements.¹⁴ The auditor cannot be content with management representations. He must ascertain the validity of the tax accrual reserves for himself.¹⁵

The Court failed to recognize an accountant work-product privilege, leaving Section 7602 to be limited by Congress, which has failed to act.¹⁶ Section 7602 is subject to only the traditional limitations and privileges. Federal law recognizes no confidential accountant relationship.¹⁷ The Court noted that confidentiality is not essential to the relationship.¹⁸ Unlike in the attorney-client relationship, the auditor is not an advocate for his client. The auditor merely determines if his client has made the required disclosures in the financial statements.¹⁹ The Court views the auditor as the public watchdog. He must be totally independent, owing complete fidelity to the public trust.²⁰

Although easy access to tax accrual workpapers may impede the audit process, the Supreme Court does recognize that there are limits to the summoning power to be kept within its reasonable bounds.²¹ For example, the summoning power of the Service cannot be used for a criminal investigation.²² Furthermore, only the federal courts can enforce an Internal Revenue Service summons since it is not self-executing.²³ Finally, the Supreme Court notes that any alternative to the present system of Internal Revenue Service investigation would involve a substantially greater invasion of the taxpayer's privacy.²⁴

¹¹ *Young*, 677 F.2d at 221.

¹² *Young*, 104 S. Ct. at 1497.

¹³ *Id.* at 1501. The Court further noted that the key for accessibility is that the summoned documents might throw light upon the correctness of the taxpayer's return. *Id.*

¹⁴ *Id.* at 1503.

¹⁵ *Id.*

¹⁶ *Id.* at 1502.

¹⁷ See *Couch v. United States*, 409 U.S. 322, 335 (1973).

¹⁸ *Young*, 104 S. Ct. at 1503.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *United States v. Bisceglia*, 420 U.S. 141 (1975).

²² See *United States v. La Salle Nat'l Bank*, 437 U.S. 298, 314, (1978).

²³ See I.R.C. §7604 (1982).

²⁴ *Young*, 104 S. Ct. at 1502 (quoting *Bisceglia*, 420 U.S. at 146).

Dickman v. Commissioner and Code Section 7872

ANN D. FULMER

Prior to the 1984 *Dickman v. Commissioner*¹ decision, interest free demand loans made to family members did not constitute taxable events. In *Dickman*, the Supreme Court held that such loans constitute taxable gifts to the reasonable value of the use of the money lent.²

Between 1971 and 1976, Paul and Esther Dickman loaned substantial amounts of money to their son Lyle and to Artesian Farms, Inc., a closely held company owned by the family.³ With two exceptions, the loans were evidenced by non-interest bearing demand notes.⁴ During the period in question, the loan's outstanding balances ranged from \$68,651 to \$699,733.⁵

Paul Dickman died in 1976. After an audit of the estate, the Commissioner of Internal Revenue determined that the loans were taxable gifts to the extent of the value of the use of the funds.⁶ The Commissioner issued notice of a gift tax deficiency, valuing the loans by multiplying the outstanding balances as of the end of each taxable quarter by interest rates taken from Internal Revenue Code (Code) Section 6621.⁷ Esther Dickman and the estate petitioned the Tax Court for redetermination of the deficiency.⁸

The Tax Court reaffirmed its earlier decision in *Crown v. Commissioner*,⁹ and held that interest-free intrafamily demand loans were not subject to the federal gift tax.¹⁰ The United States Court of Appeals for the Eleventh Circuit reversed, holding that the making of gratuitous interest-free demand notes gives rise to gift tax liability.¹¹ The Supreme Court granted certiorari to resolve the resulting conflict between the Seventh and Eleventh Circuit Courts.¹²

The Court reasoned that Code Section 2501(a)(1), which "imposes a tax upon 'the transfer of property by gift,'" reaches "any gratuitous transfer of

¹104 S. Ct. 1086 (1984) *reh'g denied* 104 S. Ct. 1932 (1984).

²*Id.* at 1094-95.

³*Id.* at 1088.

⁴*Id.*

⁵*Id.*

⁶*Id.*

⁷*Id.* at 1088, n. 2. The applicable rates ranged from six to nine percent per annum. *Id.*

⁸*Id.* at 1089.

⁹67 T.C. 1060 (1977), *aff'd* 585 F.2d 234 (7th Cir. 1978).

¹⁰49 T.C.M. (P-H) 2424, 2428 (1980).

¹¹*Dickman v. Commissioner*, 690 F.2d 812, 819 (11th Cir. 1982).

¹²*Id.* at 1088.

¹³*Id.* at 1089.

any interest in property.”¹⁴ The Court stated that the statute’s plain language imposes the gift tax on “all transfers of property and property *rights* having significant value.”¹⁵ The Court further reasoned that the gratuitous transfer of the right to use money constitutes a transfer of property because of the transfer’s “measurable economic value.”¹⁶

The Court was concerned that allowing a transfer of property through an interest-free demand loan mechanism would allow the transferor to avoid future estate tax liability by removing the funds from the estate.¹⁷ By imposing a gift tax upon such transfers, a diminution of the transferor’s estate would be prevented.¹⁸ The Court recognized that although the law allows an individual to waste the use value of his funds, tax consequences “inevitably flow” under Code Section 2501(a)(1) from the decision to transfer property by gift.¹⁹

Section 172(a) of the Deficit Reduction Act of 1984 (Act)²⁰ confines the application of the *Dickman* decision to past transactions. The Act added Code Section 7872, providing that below-market loans which are in the nature of a gift or demand loan are taxable to the lender as if the borrower had actually paid the foregone interest.²¹ Such loans result in income to the lender, and an interest deduction to the borrower. Code Section 7872 applies to below-market rate gift loans, compensation-related loans, corporation-shareholder loans, and loans with interest rate arrangements designed to avoid federal taxes.²² This new Code section provides a “de minimis” exemption for direct loans to an individual which, in the aggregate, do not exceed \$10,000.²³ However, this exemption does not apply if the loan is attributable to the purchase or carrying of income-producing assets.²⁴ The valuation of the foregone interest is accomplished by applying the appropriate rate in effect under Code Section 1274(d), compounded semiannually.²⁵

¹⁴*Id.* The Court noted that Code Section 2511(a) provides gift tax consequences where the gift is direct or indirect, and where the property is real, personal, tangible or intangible. *Id.*

¹⁵*Id.* at 1089-90. Drawing an analogy to the broad interpretation of the reach of Code Section 61 (defining gross income), the Court stated that absent an express exclusion, “any transfer meeting the statutory requirements must be held subject to the gift tax.” *Id.* at n.4.

¹⁶*Id.* at 1091.

¹⁷*Id.* at 1092.

¹⁸*Id.*

¹⁹*Id.*

²⁰Pub. L. No. 98-369, 98 Stat. 494, 699 (1984).

²¹I.R.C. §7872(a) (1984).

²²I.R.C. §7872(c) (1984).

²³I.R.C. §7872(c)(2)(A) (1984).

²⁴I.R.C. §7872(c)(2)(B) (1984).

²⁵I.R.C. §7872(f)(2)(B) (1984). Code Section 1274(d) provides that interest will be computed based on the six month average market yield on outstanding marketable obligations of the United States with remaining maturity periods of three years or less. I.R.C. §1274(d)(1)(D) (1984).

*Constitutionality of the Multiemployer Pension Plan Amendment Act
Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*¹

CLIFFORD L. DECAMP

Congress enacted the Employee Retirement Income Security Act (ERISA) which created a pension plan termination insurance program administered by the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a government corporation designed to collect premiums and administer coverage for insurance coverage for private retirement pension plans and to provide benefits to participants if those plans terminate.² ERISA was originally enacted to cover single employer plans. Coverage and payments by the PBGC to multiemployer plans was not to become mandatory until January 1, 1978.³ Between 1974 and January 1, 1978, the PBGC could exercise discretion in paying these insurance proceeds to multiemployer plans. Congress eventually realized that employers could terminate their multiemployer plans prior to the enactment date and force the PBGC to assume these obligations.⁴ Therefore, Congress enacted the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA) which made liability retroactive to April 29, 1980, thus preventing employers from terminating plans prior to January 1, 1978, in hopes of getting out of their obligations.⁵

R.A. Gray and Company is an Oregon construction company which contributed to a multiemployer pension plan called the Oregon-Washington Carpenters-Employers Pension Trust Fund.⁶ R.A. Gray and Company withdrew from the pension plan on June 1, 1980, and the pension plan's trustees assessed the company with a withdrawal penalty of \$201,359, which they refused to pay.⁷ Gray and Company filed suit in the United States District Court for the District of Oregon seeking declaratory and injunctive relief against the PBGC and the pension plan.⁸ Gray and Company sought to have the retroactive application of the MPPAA declared unconstitutional on the grounds that it violated both the Due Process Clause and the Equal Protection Clause of the fifth amendment.⁹ Gray and Company further contended that the

¹104 S. Ct. 2709 (1984).

²*Id.* at 2713.

³*Id.*

⁴*Id.* at 2713-14.

⁵*Id.* at 2715.

⁶*Id.* at 2715-16.

⁷*Id.* at 2716.

⁸*Id.*

⁹*Id.*

Multiemployer Pension Plan Amendment Act was arbitrary and irrational in attempting to provide retroactive application of its provisions, and impaired Gray's collective bargaining agreements.¹⁰

The United States District Court for the District of Oregon found against Gray and Company.¹¹ In coming to its decision, the district court decided the issue of whether the MPPAA was arbitrary and irrational by applying the test developed in *Nachman Corp. v. Pension Benefit Guaranty Corp.*¹² This test has four factors. The first factor is the reliance interests of the parties. The second is whether the interest impaired was in an area previously subjected to regulatory control. The third concerns the equities of imposing legislative burdens on the employers. The last is whether there were provisions in the law that would limit or modify the impact of the burden that was imposed.¹³ The district court looked to these factors and decided that the employees' reliance on the promised pension benefits outweighed Gray's reliance.¹⁴ Additionally, the court did not find that the retroactive nature of the MPPAA was an irrational solution to the situation.¹⁵

The Ninth Circuit Court of Appeals reversed the district court decision applying the same four factor test.¹⁶ That court decided that the MPPAA did violate the Due Process Clause of the Constitution by impairing Gray and Company's right to the collective bargaining agreement.¹⁷ Additionally, they found that the MPPAA also placed too great a burden on the employer.¹⁸

The Supreme Court in a decision written by Justice Brennan, reversed the Ninth Circuit decision and found that the test developed in the *Nachman* case was unconstitutional and not to be applied. The Court stated that legislation under review by the Court has a strong presumption of constitutionality,¹⁹ even when it is applied retroactively.²⁰ The Court further stated that Congress had considered the competing interests when it decided to enact the MPPAA. Furthermore, the Court stated that it would not substitute its judgment for decisions made by Congress.²¹ Therefore, the Court found that there was a ra-

¹⁰R.A. Gray & Co. v. Oregon-Washington Carpenters-Employers Pension Trust Fund, 549 F. Supp. 531, 534 (D. Or. 1982).

¹¹*Id.* at 533.

¹²592 F. 2d 947 (7th Cir. 1979).

¹³*Id.* at 960.

¹⁴549 F. Supp. at 537.

¹⁵*Id.* at 538.

¹⁶705 F. 2d 1502, 1511-14 (9th Cir. 1983).

¹⁷*Id.* at 1513.

¹⁸*Id.* at 1514.

¹⁹104 S. Ct. at 2717.

²⁰*Id.* at 2718.

²¹*Id.* at 2718-19.

tional purpose in applying the retroactive application of the law, in order to prevent employers from withdrawing when they faced the possibility of higher contributions.²² Congress had correctly concluded that mass movement of employers in this manner could destabilize the whole program and had sought to prevent such a thing from happening.²³

By failing to address the rationality of the legislative act, the Court reaffirmed its policy of deference to Congress when reviewing legislation. Thus it would appear that in the area of pension legislation, Congress reigns supreme. In keeping with this, Congress repealed the retroactive provisions of the MPPAA in the Deficit Reduction Act of 1984.²⁴

²²*Id.* at 2719.

²³*Id.*

²⁴Pub. L. No. 98-369, sec. 558. 98 Stat. 494, 899 (1984).

South Carolina v. Regan — Defining the Dimensions Of The Anti-Injunction Act

STEVEN A. DIMENGO

In *South Carolina v. Regan*¹, the Supreme Court ruled that the Anti-Injunction Act (Act)² barred only those suits where Congress has provided the aggrieved party with an alternate avenue to contest the legality of a tax.³ Since Congress did not grant South Carolina an alternate remedy to contest the legality of the particular tax in question, the Act did not bar the suit. In *South Carolina v. Regan*, South Carolina invoked the Courts original jurisdiction, seeking an injunction and other relief.⁴ The complaint was filed against the Secretary of the Treasury of the United States. The State claimed that Section 103(a) of the Internal Revenue Code as amended by Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)⁵ is unconstitutional.⁶ Section 103(a) exempts interest earned on the obligations of a state from a taxpayer's gross income.⁷ However, to qualify for the exemption, the obligation must be in registered form as opposed to bearer form.⁸ South Carolina argued that it was effectively denied the right to issue bearer bonds, since investors would demand higher rates of interest on such bonds due to the taxability of the interest.⁹ Accordingly, the State argued that its borrowing power as thus restricted impaired its separate and independent existence.¹⁰ South Carolina contended that such an impingement on the State's power violates the Tenth Amendment.¹¹ Avoiding the merits of the controversy, the Secretary argued that South Carolina's action was barred by the Anti-

¹104 S. Ct. 1107 (1984).

²I.R.C. §7421. Section 7421(a) provides:

(a) Tax—Except as provided in Sections 6212(a) and (c), 6213(a), 6672(b), 6694(c), 7426(a) and (b)(1), and 7429(b), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed *Id.*

³*Regan*, 104 S. Ct. at 1111.

⁴*Id.* at 1110.

⁵Pub. L. No. 97-248, 96 Stat. 324, 596 (1982).

⁶*Id.*

⁷I.R.C. §103(a).

⁸Section 201(b)91) of TEFRA added I.R.C. §103(j) which provides:

"(j) obligations must be in registered form to be tax-exempt.

(i) In general — nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from federal income tax for interest on any registration-required obligation unless the obligation is in registered form."

Id. Generally, a registration-required obligation is an obligation offered to the public with a maturity of greater than one year. I.R.C. §103(j)(2).

⁹*Regan*, 104 S. Ct. at 1111.

¹⁰*Id.*

¹¹*Id.* Furthermore, South Carolina argued that the doctrine of intergovernmental tax immunity is violated by a tax on the interest earned on state obligations. *Id.*

Injunction Act.¹²

The Court analyzed the intent of the Act and determined that injunctions were prohibited only when the statutory scheme provided an alternate remedy. The Court rejected the Secretary's contention that *Enochs v. Williams Packing & Navigation Co. Inc.*¹³ provides the only exception to the Act.¹⁴ The Court stated that *Williams Packing* was not relevant since the taxpayer had the alternate remedy of a suit for a refund.¹⁵ The Court noted that cases after *Williams Packing* specifically focused on the availability of a refund suit to the taxpayer when denying him injunctive relief.¹⁶

The Court noted that Section 7478 of the Internal Revenue Code does not provide South Carolina with an action to contest the constitutionality of taxing unregistered obligations of the state.¹⁷ The Secretary argued that the State's remedy lay in persuading a purchaser of its bearer bonds to contest the constitutionality of Section 310(b)(1) of TEFRA.¹⁸ The Court rejected this argument by stating "reliance on the remedy suggested by the Secretary would create the risk that the Anti-Injunction Act would entirely deprive the State of any opportunity to obtain review of its claims."¹⁹

Finally, the Court rejected the Secretary's argument that it should not invoke its original jurisdiction since another adequate forum existed.²⁰ The Court noted that Section 310(b)(1) would materially infringe upon South Carolina's borrowing power.²¹ The Court stated: "[u]nquestionably, the manner in which a State may exercise its borrowing power is a question of vital importance to all fifty States."²²

Although *South Carolina v. Regan* does not address the merits of the State's claim, it clarifies the reach of the Anti-Injunction Act. The Act applies only when the suitor does not have alternate remedies.

¹²*Id.*

¹³370 U.S. 1 (1962).

¹⁴*Regan*, 104 S. Ct. at 1111. In *Williams*, the Court noted that the Act would not apply if the taxpayer could demonstrate certain success on the merits and that irreparable harm would result from collection. *Williams*, 370 U.S. at 6-7.

¹⁵*Regan*, 104 S. Ct. at 1112.

¹⁶*Id.* at 1112-13. The Court analyzed *Bob Jones University v. Simon*, 416 U.S. 725 (1974); *Alexander v. Americans United Inc.*, 416 U.S. 752 (1974); and *United States v. American Friends Service Committee*, 419 U.S. 7 (1974). Furthermore, the Court noted that the 1966 amendment to the Anti-Injunction Act was not relevant to the issue before the Court. The amendment addressed the rights of third parties whose property rights competed with federal tax liens. The amendment granted the third parties a right of action against the federal government. *Regan*, 104 S. Ct. at 1113-14.

¹⁷*Regan*, 104 S. Ct. at 1117.

¹⁸*Id.* at 1115.

¹⁹*Id.*

²⁰*Id.* at 1116.

²¹*Id.*

²²*Id.*

Amendments to Fraudulent Returns *Badaracco v. Commissioner*

ANN D. FULMER

In *Badaracco v. Commissioner*,¹ the Supreme Court held that Internal Revenue Code (Code) Section 6501(c)(1) allows the Service to assess taxes at any time on fraudulent returns, even if the returns have later been amended by nonfraudulent returns.

Code Section 6501(a) provides a three year statute of limitations for the assessment of taxes, and prohibits the initiation of court proceedings to collect such taxes without assessment after that period of time has elapsed. Section 6501(c)(1) provides an exception to that rule, stating: “[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.”²

Ernest Badaracco, Sr., and Ernest Badaracco, Jr., filed fraudulent partnership and individual returns [for] the years 1965 through 1969.³ While under investigation by a federal grand jury in 1971, the taxpayers filed nonfraudulent amended returns for the years in question.⁴ Both men were indicted for filing false and fraudulent returns, and they later plead guilty in respect to the returns filed for 1967.⁵

In 1977, the Commissioner issued deficiency notices on account of fraud for each of the tax years in question, amounting to fifty percent of the underpayment of the basic tax.⁶ The taxpayers sought redetermination of the asserted deficiencies and claimed that the Commissioner’s action was barred by Code Section 6501(a).⁷ The Tax Court agreed with the taxpayers,⁸ but the Third Circuit Court of Appeals reversed.⁹ Because of a conflict in the circuits, the Supreme Court granted certiorari.¹⁰

The Supreme Court looked to the “unqualified language” of Section

¹104 S. Ct. 756 (1984).

²I.R.C. §6501(c)(1).

³104 S. Ct. at 759.

⁴*Id.*

⁵*Id.* The remaining counts of the indictment were dismissed. *Id.*

⁶104 S. Ct. at 759-60. The Commissioner asserted liability under Code Section 6653(b), the so-called “fraud penalty.” *Id.* at 760.

⁷104 S. Ct. at 760.

⁸42 T.C.M. 573 (P-H) ¶ 81, 404 (1981).

⁹693 F.2d 298 (3rd Cir. 1982).

¹⁰103 S. Ct. 2084 (1983).

6501(c)(1), and noted that nothing in the statute “can be construed to suspend its operation in . . . light of a fraudulent filer’s subsequent repentant conduct.”¹¹ Furthermore, by its wording, Section 6501(a) fails to indicate that a taxpayer can cause the three year statute of limitations to be reinstated by filing an amended return.¹² The Court stated that to hold otherwise would allow taxpayers to file fraudulent returns in the hopes that the fraud would not be discovered, and then, if discovered, to pay only the tax originally owed, thus making the fraud penalty a nullity.¹³

The Court rejected the Badaraccos’ argument that their original returns, to the extent they were fraudulent, were made nullities for the purpose of applying Section 6501(a) because of the filing of the nonfraudulent amended returns. The Court stated that “the return” referred to in that section is the original return, and that an amended return does not become “the return” upon filing.¹⁴ The Court noted that proving fraud is an area of great difficulty for the Commissioner, and since the records underlying the filed return may also be false or have been destroyed, more time is needed to complete an investigation.¹⁵ Furthermore, although an amended return may ultimately prove to be accurate, it “comes with no greater guarantee of trustworthiness than any other submission. . . . [as it] comes from a taxpayer who already has made false statements. . . .”¹⁶ The Court noted that the three year period may not provide sufficient time for the Commissioner to prove fraudulent intent.¹⁷ Thus, Section 6501(c)(1)’s “at any time” provision is the appropriate standard for assessing taxes in the case of fraudulent returns.

¹¹104 S. Ct. at 761. (fn. omitted).

¹²104 S. Ct. at 762.

¹³*Id.*

¹⁴104 S. Ct. at 763-64.

¹⁵104 S. Ct. at 764.

¹⁶*Id.*

¹⁷104 S. Ct. at 765.

Interest Payments On Promissory Notes For Clifford Trusts *Strimling v. Commissioner*

ANNETTE SKINNER

In *Strimling v. Commissioner*,¹ the Tax Court held that interest paid on promissory notes used to establish clifford trusts constitutes nondeductible gifts rather than deductible interest payments. The Ninth Circuit Court of Appeals affirmed in a brief per curiam opinion.²

Ten sets of parents (all Nevada residents) established clifford trusts for the benefit of their children. Each of these trusts was funded with \$10.00 and the taxpayers' promissory notes, ranging from \$10,000 to \$85,000, made payable to the trustees.³ The taxpayers claimed deductions for the interest payments made on the notes under I.R.C. Section 163(a). The IRS filed a deficiency notice disallowing these deductions.

The Tax Court relied on previous cases⁴ to hold that interest paid on an unenforceable obligation is not deductible,⁵ and further relied on *Commissioner v. Estate of Bosch*⁶ to state that whether an obligation is legally enforceable is a question of state law.⁷ Under Nevada law, the donee of a promissory note cannot enforce the gift against a donor.⁸ The taxpayers contended that although there was no consideration from the donees, the trustees' assumption of fiduciary duties constituted a substitute for consideration and thereby rendered the notes enforceable.⁹ The Tax Court found no support for this proposition and, relying on Nevada law, held that a promise to do what one is already legally bound to do does not constitute valid consideration.¹⁰ The court concluded that since the taxpayers' notes were not legally enforceable in Nevada, the interest payments were wholly gratuitous and therefore not deductible under I.R.C. Section 163(a).¹¹

¹52 T.C.M. (P-H) ¶ 83,281 (1983).

²*Strimling v. Commissioner*, 734 F.2d 1377 (9th Cir. 1984).

³52 T.C.M. (P-H) ¶ 83,281.

⁴*Linder v. Commissioner*, 68 T.C. 792, 796 (1977); *Brown v. Commissioner*, 25 T.C. 920 (1956), *aff'd* 241 F.2d 827 (8th Cir. 1957); *Day v. Commissioner*, 42 B.T.A. 109 (1940), *aff'd* 121 F.2d 856 (2d Cir. 1941).

⁵52 T.C.M. (P-H) ¶ 83,281.

⁶387 U.S. 456 (1957).

⁷52 T.C.M. (P-H) ¶ 83,281.

⁸*Id.*

⁹*Id.*

¹⁰*Id.*

¹¹*Id.*

*Section 162(a)(3) Deduction Of Gift-Leaseback Rental Payment
May v. Commissioner*

CHERLYN PHERIGO

In what the court described as “a typical ‘gift-leaseback’ situation,”¹ the Ninth Circuit has affirmed the deductibility, as a business expense, of rental payments made to a trust established by the taxpayer for the benefit of his children.² The taxpayers, Dr. May and his wife, by deed transferred their entire interest in a medical building to an irrevocable trust with their four children as beneficiaries. Dr. May continued to conduct his practice in the building as a lessee and paid the trust a monthly rental. When the May’s deducted the rent paid as an ordinary and necessary business expense, the Commissioner of Internal Revenue assessed a deficiency.³ The Tax Court held that the payments were deductible under I.R.C. Section 162(a)(3).⁴

In reaching its decision, the Ninth Circuit relied almost exclusively on its opinion in *Brooke v. United States*,⁵ a 1972 case allowing a similar gift-leaseback deduction. In *Brooke* the court stated that “[t]he fundamental issue presented involves the sufficiency of the property interest transferred.”⁶ The factors used to test the sufficiency of the transfer are: (1) the duration of the transfer, (2) the controls retained by the donor, (3) the use of the gift property for the benefit of the donor, and (4) the independence of the trustees.⁷

The *May* court, applying the *Brooke* test, found that the property interest transferred was sufficient to allow a Section 162(a)(3) deduction.⁸ The court found that the written trust instrument used by Dr. May and his wife in 1971 effectively and irrevocably transferred title gratuitously to their children in trust.⁹ It contained language plainly showing the transferor’s present intent to transfer as required by California law.¹⁰ In addition, the court held that the taxpayers “did not retain substantially the same control over the property” as they

¹May v. Commissioner, 723 F.2d 1434, 1435 (9th Cir. 1984).

²*Id.*

³76 T.C. 7, 11 (1981).

⁴*Id.* at 15. All references are to the 1954 Internal Revenue Code, 26 U.S.C. sections 1 *et. seq.*, including all amendments or revisions thereto. Section 162(a)(3) permits the deduction of ordinary and necessary business rental expenses.

⁵468 F.2d 1155 (9th Cir. 1972). In *Brooke* the taxpayer/physician also conveyed his medical building to his children as a gift. The taxpayer was appointed guardian of his children’s estate and paid himself, as guardian, the reasonable rental value of his medical offices. The rent was used for his children’s health, education, and insurance expenses. *Id.*

⁶*Id.* at 1157.

⁷*Id.* (citing *Mathews v. Commissioner*, 61 T.C. 12 (1973), *rev’d* 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976)).

⁸723 F.2d at 1436-37.

⁹*Id.* at 1437.

¹⁰*Id.*

had before the gift in trust, and that the trustees were "sufficiently independent."¹¹ Finally, the court held that the gift property was not used for the benefit of Dr. May. His use was "strictly as a lessee" according to the oral lease between himself and the trust.¹² Since the circumstances warranted taxing the rental income to the trust, and the situation was not a "sham or a fraud,"¹³ the court ruled that the deduction must be allowed.

The significance of the *May* decision is that it affirmed that the Ninth Circuit's "business purpose" analysis. The court will first determine the validity of the transfer of the property and then allow a deduction if the leaseback rental payments alone have a business purpose.¹⁴ Only the leaseback must be "grounded in professional or economic reality." The gift portion need not be for a business purpose.¹⁵ The Commissioner's position is that the gift and leaseback are inseparable events, and that the language of Section 162 requires both to have been ordinary and necessary.¹⁶

In conclusion, unless the circuit requires that even the gift portion of a gift-leaseback have a business purpose, or that the two transactions are inseparable, the rental payments made to a trust will be deductible under Section 162(a)(3) if the *Brooke* criteria are met.

¹¹*Id.* Dr. May and a friend, Harlos Gross, were the trustees. Gross, whose duties consisted of making quarterly inquiries to establish that the rent had been paid, testified that he felt independent of Dr. May. 76 T.C. at 14-15. The Tax Court agreed. *Id.*

¹²723 F.2d at 1437.

¹³*Id.* (quoting *Brooke*, 468 F.2d at 1158).

¹⁴723 F.2d at 1436. This analysis is also used by the 3rd, 7th and 8th circuits. *Id.* at fn. 2.

¹⁵*Id.*

¹⁶Section 162 requires, by its wording, that the lease have a business purpose. The Commissioner's position is also the position taken by the 4th and 5th Circuits. *Id.*

Perjury Provision: United States v. Greenburg

MARK A. GIANCARLI

Recent circuit courts of appeals decisions have given the Section 7206(1) perjury provision a great deal of bite along with its bark,¹ by providing for prosecution even where false statements on a return do not result in the underpayment of tax.

Section 7206(1) subjects "any person who willfully makes and subscribes any return . . . under the penalties of perjury . . . which he does not believe to be true and correct as to every material matter . . ." to criminal prosecution, fines up to \$100,000 for individuals,² and/or imprisonment of up to 3 years.³

In the most recent decision interpreting Section 7206(1), the Second Circuit affirmed a lower court decision that convicted Jack Greenburg, an accountant, of 3 counts of filing a false return. Greenburg was sentenced to a prison term of one year and one day.⁴

In 1978, Greenburg, a participant in a joint venture, caused personal expenses to be classified as business expenditures and caused compensation payments to co-venturers or business investment payments to be classified as loans. Despite these misallocations, the joint venture accurately reported its net taxable income and no tax deficiency resulted. Also in 1976 and 1977, Greenburg overreported his wife's income and underreported his own. These misallocations resulted in an understatement of only forty-eight dollars. Greenburg argued first that the question of materiality was an issue for the jury and secondly that the misstatements were not material because they resulted in minimal underpayments.⁵

The Court rejected both arguments, concluding:

that materiality was a question of law to be decided by the court . . . [and] the purpose of §7206(1) is not simply to ensure that the taxpayer pay the proper amount of taxes. . . . Rather, that section is intended to ensure also that the taxpayer not make misstatements that could hinder the Internal Revenue Service . . . in carrying out such functions as the verification of the accuracy of that return or a related tax return.⁶

¹United States v. Greenburg, 735 F.2d 29 (2d Cir. 1984); United States v. Whyte, 699 F.2d 375 (7th Cir. 1983); United States v. Gaines, 690 F.2d 849 (11th Cir. 1982); United States v. Strand, 617 F.2d 571 (10th Cir.), *cert. denied*, 449 U.S. 841 (1980); United States v. Taylor, 574 F.2d 232 (5th Cir.), *cert. denied*, 439 U.S. 893 (1978); United States v. Tsanas, 572 F.2d 340 (2d Cir.), *cert. denied*, 435 U.S. 995 (1978); United States v. Romanov, 509 F.2d 26 (1st Cir. 1975).

²I.R.C. §7206(1) (1984).

³*Id.*

⁴United States v. Greenburg, 735 F.2d 29 (2d Cir. 1984).

⁵*Id.*

⁶*Id.* at 31.

Anyone who knowingly makes false statements on a tax return will be subject to prosecution under Section 7206(1) even if the false statements do not result in an underpayment of tax.

*“Trade or Business”
Ditunno v. Commissioner*

TERRY VINCENT

Although the term “trade or business” appears in over 200 sections of the Internal Revenue Code, there is no authoritative or codified definition of the term.¹ The reason may be that although the term “trade or business” is deceptively simple, it remains impossible to establish an all-inclusive definition of the phrase as it is used throughout the Code.

In *Ditunno v. Commissioner*,² the Tax Court faced the issue of whether the taxpayer was engaged in a “trade or business” within the meaning of I.R.C. Section 162. Anthony Ditunno was a full-time gambler who did not receive income from any other source,³ and who bet entirely on his own accord.⁴ He did not sell betting tips, collect commissions for placing bets, or work as a bookmaker.⁵ Mr. Ditunno’s activity was confined to betting his own money.⁶ Ditunno deducted his gambling losses as business expenses to arrive at his adjusted gross income in accordance with I.R.C. Section 62(1).⁷

To determine whether Ditunno properly concluded his gambling activity constituted a “trade or business,” the Tax Court looked to past judicial interpretations of the term. The evolution of the judicial interpretation of the term “trade or business” is most often traced to *Flint v. Stone Tracy Co.*⁸ The Supreme Court, interpreting the meaning of “trade or business” within the Corporation Tax Act of 1909⁹ said, “[b]usiness’ is a very comprehensive term and embraces everything about which a person can be employed. [A business is] that which occupies the time, attention and labor of men for the purpose of livelihood or profit . . .”¹⁰

In 1940, Mr. Justice Frankfurter expressed a somewhat narrower view in his concurring opinion in *Deputy v. duPont*¹¹ when he stated: “. . . carrying on

¹Some sections provide definitions for the term as it applies specifically to that section within the Internal Revenue Code. See generally, I.R.C. §§335, 502, and 7701. (1983).

²80 T.C. 362 (1983) (Tannenwald, J., dissenting).

³*Id.* at 364.

⁴*Id.*

⁵*Id.*

⁶*Id.*

⁷I.R.C. §62(1) (1983) defines an individual’s adjusted gross income as gross income minus deductions “which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.” *Id.*

⁸220 U.S. 107 (1911).

⁹Tarriff Act of 1909, Pub.L. No. 61-5, 36 Stat. 11.

¹⁰220 U.S. 107 (1910).

¹¹308 U.S. 488 (1940).

any trade or business; within the contemplation of Section 23(a)¹², involves holding one's self out to others as engaged in the selling of goods or services."¹³ One year later in *Higgins v. Commissioner*¹⁴ the Supreme Court again had before it the issue of the meaning of "trade or business" as used in I.R.C. Section 23(a). Even though the facts in *Higgins* were similar to those in *duPont*¹⁵ and the lower court in *Higgins* had relied in part on Justice Frankfurter's concurring opinion in *duPont*,¹⁶ the Supreme Court did not adopt that test.¹⁷ Instead the Court stated "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."¹⁸

Shortly after the *Higgins* decision, Congress responded by enacting Section 212 of the Code¹⁹ which allows an individual²⁰ to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income."²¹ Thus Section 212 allows a taxpayer to deduct expenses from the gross income of an income-producing activity, even though that activity itself does not qualify as a trade or business.

The *Ditunno* court looked to the *Higgins* test and, after reviewing the facts²² and circumstances, the court held that Ditunno was in the trade or business of gambling within the meaning of Section 62(1).²³ This judicial interpretation of what constituted a trade or business, as well as the result in *Ditunno*, were not followed by a unanimous court. In his dissenting opinion, Chief

¹²I.R.C. §23(a) (1939) is the predecessor of I.R.C. §162 (1983).

¹³308 U.S. at 499 (Frankfurter, J., concurring).

¹⁴312 U.S. 212 (1941).

¹⁵Both *Higgins* and *duPont* dealt with investors who deducted expenses relating to the management of their own securities portfolios.

¹⁶111 F.2d at 797.

¹⁷Because the facts in *duPont* and *Higgins* were so similar and the fact that *duPont* was decided only one year before *Higgins*, *Higgins* provided a convenient time for the Supreme Court to adopt Justice Frankfurter's test.

¹⁸312 U.S. at 217.

¹⁹Sec. 121, 56 Stat. 798 (1942). The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequality. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable. H. R. 2333, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 372, 410.

²⁰"The Section 152-Section 212 dichotomy that exists with respect to individual taxpayers has no applicability to corporate taxpayers; accordingly, expenses incurred by a corporation in managing its passive investments are considered to be deductible under Section 162" Roth, *Trade or Business Requirement of Sec. 162 and the Deductibility of Preoccupancy Expenses Incurred in Rental Real Estate Projects*, 57 TAXES 33, 39 (1979).

²¹I.R.C. §212(2) (1983).

²²The court noted that Ditunno gambled on a daily basis, devoted his full time to gambling activities, and, in placing bets, was not assured a return. 80 T.C. at 372.

²³*Id.*

Judge Tannenwald felt the majority ignored both the nature of the *Higgins* test and a long-accumulated body of case law.²⁴ Judge Tannenwald stated that holding one's self out to others as being engaged in the selling of goods or services was an essential ingredient to the interpretation of the term "trade or business".²⁵ By dismissing this ingredient, Judge Tannenwald stated the majority's opinion would "wreak havoc on the concept of trade or business."²⁶

Although the Tax Court in *Ditunno* preferred a broad interpretation of the term "trade or business," its decision has yet to be expressly followed by other courts. The Second Circuit Court of Appeals chose not to follow the *Ditunno* reasoning in reversing *Gajewski v. Commissioner*²⁷. In reviewing its past decisions, the Second Circuit Court identified a number of requirements the taxpayer must satisfy to be engaged in a trade or business. The court stated that a taxpayer must: 1) be regularly and actively involved in the activity; 2) undertake the activity with the expectation of profit; and 3) hold himself out to others as being engaged in the selling of goods or services.²⁸ The court held firm to the holding one's self out requirement, stating: "[s]uch a requirement, in addition to describing the most common characteristics of the trader or businessman, is administratively workable and fair to the taxpayers."²⁹

To date all courts interpreting the term "trade or business" have held that the holding one's self out to others requirement to be valid with the exception of the Tax Court. The extensive use of the term throughout the Code accentuates the need for uniformity among the courts when interpreting the term. The undesirability of these varying interpretations of the same term within a single section of the Code by different courts is too obvious for comment.

²⁴*Id.* at 373.

²⁵*Id.*

²⁶*Id.* at 372.

²⁷52 T.C.M. (P-H) ¶ 83,133 (1983) *rev'd* 723 F.2d 1062 (2d Cir. 1983).

²⁸723 F.2d at 1065.

²⁹*Id.* at 1067.

The Doctrine of Election Grynberg v. Commissioner

CHERLYN PHERIGO

In *Grynberg v. Commissioner*¹ the Tax Court held, once again, that the doctrine of election prohibits a taxpayer from revoking an election made on his timely-filed return.² The chief argument by the taxpayer-petitioner in this case, that their election was based on a mistake of fact and was therefore revocable on an amended return, was rejected by the court. In the court's opinion, the doctrine of election is *not* an "outmoded, equitable doctrine," but a viable, healthy one which precludes petitioner's claim.³ The court did not take this opportunity to abandon the applicability of this traditional and well-established device of federal tax law, but chose instead to affirm its effect in such situations.

The doctrine of election has been consistently held to consist of: 1) an available, free choice between two or more alternatives and 2) an overt act by the taxpayer communicating the choice to the Commissioner⁴. It has been applied in a wide variety of contexts within the tax realm.

In *Grynberg*, the taxpayer and his wife made an affirmative Code Section 170⁵ election to have their charitable contribution deduction calculated according to Section 170(b)(1)(D)(iii).⁶ Pursuant to such provision, the fair market value (FMV) of donated property is reduced by fifty percent of the amount which would have been long term capital gain if the property had been sold at FMV, subject to a limit of fifty percent of adjusted gross income. Any remainder is carried over to subsequent years. This election was properly made.⁷ An IRS audit resulted in an increase in the taxpayer's gross income, thereby increasing the deductible amount for charitable contributions in the first year, and decreasing the contribution carryover to the second year. In response, the taxpayers requested that their election be revoked and that their deduction be recalculated under Code Section 170(b)(1)(C)(i), where the FMV of the donated property, up to thirty percent of gross income, is deductible. The court rejected petitioner's contention that the mistake of fact exception to the doctrine of election allows revocation. It found the tax effect of the audit on the charitable contributions deductions to be based upon items that were unrelated to that

¹83 T.C. 255 (1984).

²The *Grynberg* court also reached a decision on an issue involving the prepayment of delay rentals which is not discussed in this article.

³83 T.C. at 260-61.

⁴10 MERTENS, J., *THE LAW OF FEDERAL INCOME TAXATION*, § 60.19, at 73 (1976).

⁵All section references are to the Internal Revenue Code of 1954, as amended.

⁶Now Code §170(b)(1)(C)(iii).

⁷The election was made pursuant to the requirements of Treas. Reg. §1.170A-8(d)(2)(c).

deduction, and the “unexpected tax consequences” were not a mistake of fact.⁸

In reaching this conclusion, the court recognized that a material mistake of fact has, in the past “vitiat[e] the binding nature of an election,”⁹ citing *Roy H. Park Broadcasting, Inc. v. Commissioner*,¹⁰ and *Meyer’s Estate v. Commissioner*.¹¹ In *Park*, the mistake of fact was found to involve an unanticipated change in FCC policy which allowed the petitioner to obtain control of a radio station that he reasonably believed would not be obtained. This resulted in a change in Code Section 1071 elective treatment of its sale of shares as an involuntary conversion¹². In *Meyer*, the taxpayers relied in good faith upon an understated corporate earned surplus figure in making a Code Section 112(b)(7) election to treat the amount as ordinary income. The Fifth Circuit allowed the taxpayer to amend the return seeking capital gain treatment instead.¹³

The *Grynberg* court found neither of these exception cases applicable, but rather found convincing the general rule that, “[o]nce the taxpayer makes an elective choice, he is stuck with it.”¹⁴ Furthermore the court stated: “[w]here unexpected tax consequences arise solely due to unrelated audit adjustments, no material mistake of fact has occurred.”¹⁵ The change in *Grynberg*’s gross income figure was not found to constitute a mistake of fact. In deciding what effect the audit change had, the court apparently relied upon the statement in *Estate of Stamos v. Commissioner*¹⁶, that mere “[o]versight, poor judgement, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences of making an election, miscalculation, and unexpected subsequent events have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the Code.”¹⁷

The court felt compelled by this precedent and also by the treatment by the Tenth Circuit (where the *Grynberg* case would be appealed) of elections and not subject to any of its exceptions. The events here could be described within the above quotation as either a “misunderstanding of the law” as it related to the taxation of their unrelated items, or as an “unexpected subsequent event” namely, the audit adjustment of their gross income.

⁸83 T.C. at 263.

⁹83 T.C. at 261-62.

¹⁰78 T.C. 1093 (1982).

¹¹200 F.2d 592 (5th Cir. 1952).

¹²78 T.C. 1093 (1982).

¹³200 F.2d at 597.

¹⁴83 T.C. at 261 citing *Roy H. Park Broadcasting, Inc. v. Comm’r*, 78 T.C. 1093, 1134 (1982).

¹⁵83 T.C. at 263. See *Estate of Darby v. Wiseman*, 323 F.2d 792 (10th Cir. 1963); *Estate of Stamos v. Comm’r*, 55 T.C. 468 (1970).

¹⁶55 T.C. 468 (1970).

¹⁷83 T.C. at 262, quoting *Stamos*, 55 T.C. at 474.

Petitioners also argued that the legislative history of the charitable deduction provisions of the Tax Reform Act of 1969 supported their claim, and that the language of Regulation Section 1.170A-8(d)(2) does not necessarily mean the election on the original return.¹⁸ Both arguments were summarily dismissed by the court.

The court concluded that the doctrine of election applied to the *Grynberg* case, and announced its decision without reservation, qualification, extension or further restriction. It held that a mistake as to tax consequences is not a mistake of fact, and that revocation of the election will not be permitted.¹⁹ The fact that a taxpayer's decision later turned out to have been unwise does not mean that no real decision has been made. The taxpayer is stuck with his decision.

The reason for the doctrine's prohibition of revocation after the period for filing is that a revocation on an amended return would impose "burdensome uncertainties upon the administration of revenue laws."²⁰ In this case it appears clear that administrative certainty is more than mere convenience. Every audit culminating in a change of an item on the taxpayer's return would result in an amended return seeking an alternative election if it had more favorable tax consequences. Realizing that this occurs frequently, especially with the Code Section 170 charitable deduction election, some inequity to the directly-affected taxpayer must be sacrificed in such situations to the interests of the collection system and the taxpayers indirectly affected thereby.

¹⁸In light of its disposition of the case under the doctrine of election, the court did not address this second argument.

¹⁹83 T.C. at 263.

²⁰304 U.S. at 194.

*Partial Termination of a Section 401 Plan
Tipton and Kalmbach, Inc. v. Commissioner*

DAVID DEVANY

In *Tipton and Kalmbach, Inc. v. Commissioner*,¹ the Tax Court considered whether a partial termination of a Section 401(a) plan occurred when employee-plan participants were discharged solely due to adverse economic conditions. In *Tipton and Kalmbach*, a consulting engineering corporation discharged 34 percent and 51 percent of its profit sharing plan participants during 1971 and 1972 respectively. These reductions were attributed to a decrease in volume of the taxpayer's business rather than any liquidation of the taxpayer.² Since the discharged employees had no non-forfeitable rights to benefits, the continued qualification of the taxpayer's plan under Section 401(a) hinged upon whether the reductions constituted a partial termination.

The taxpayer argued that since the reduction in plan participation was due to adverse economic conditions which were beyond its control, no partial termination had occurred.³ It emphasized that there was no intention to deprive plan participants of their benefits. The IRS contended that adverse economic conditions would not excuse what was otherwise a partial termination.⁴ The court, in holding that there was a partial termination,⁵ did not look to the intention of the employer but simply to the fact that there was a reduction in plan participation. According to the court, Congress, in enacting I.R.C. Section 401(a)(7), sought to protect employees from forfeiting their retirement benefits, regardless of the employer's intent.⁶ As such, if the taxpayer's position were to be accepted, there would be significant forfeiture of accrued, but vested, benefits. The court found this result to be clearly outside of the legislative intent of Section 401(a)(7).⁷

The taxpayer further asserted that a holding that there was a partial termination would: (1) make it impossible for companies operating in industries subject to workforce fluctuations to maintain qualified plans, and (2) lead to discrimination against long term employees because laid off short term employees would be automatically vested, whereas long term employees would not be fully vested before the time established in the vesting schedule.⁸ The

¹83 T.C. 154 (1984).

²*Id.* at 155.

³*Id.* at 159.

⁴*Id.*

⁵*Id.* at 160.

⁶*Id.* at 161.

⁷*Id.*

⁸*Id.*

court rejected the first argument, since a plan would qualify under Section 401(a) by simply granting terminated employees non-forfeitable rights to benefits.⁹ Partial termination would merely require that the accrued benefits of terminated employees be treated as vested rights, rather than forfeitures subject to reallocation to remaining participants. The court likewise rejected the second argument because it was based on the incorrect assumption that the discharges were temporary, rather than permanent in nature.¹⁰

In conclusion, the rule set forth by the court is that the employer's intent is irrelevant in determining whether a partial termination has occurred. If there is a significant reduction in the number of plan participants, a partial termination has occurred. If those discharged employees have no non-forfeitable rights to benefits, the plan does not qualify under Section 401(a).

⁹*Id.* at 162.

¹⁰*Id.* The court indicated that this argument would only have merit where the factors demonstrate that short term employees were rehired, returned to work with accrued benefits fully vested, and worked alongside long term employees who may not have been fully vested. The facts in the present case did not support these assumptions. *Id.*

Life Insurance Changes Under the Tax Reform Act of 1984

CLIFFORD L. DECAMP

Generally, the Tax Reform Act of 1984 made several changes in the area of life insurance taxation. Probably the most important change was the addition of I.R.C. Section 7702, defining life insurance for tax purposes. In order to be classified as life insurance and thus receive favorable tax treatment, a policy must meet the state requirements for life insurance and one of the two alternative tests. The first of these alternative tests is the cash value accumulation test.¹ The second is a combination of the guideline premium² and cash value corridor test.³

Under the cash accumulation test, the cash surrender value of the life insurance contract cannot at any time exceed the net single premium that would be necessary to fund future benefits at the same level. "Cash surrender value" means the amount the policyholder is entitled to receive if he cashed in the policy or the amount the policyholder can borrow against. The purpose behind this component is to exclude those contracts with interest orientation from favorable life insurance treatment. The "net single premium" is computed by using the greater of the annual effective rate of four percent or the rate guaranteed on the issuance of the life insurance contract.⁴ The "future benefits" are the death and endowment benefits. The total of any qualified additional benefits are not to be taken into account in determining the net single premium. However, the charge stated in the insurance contract for the qualified additional benefit is treated as a future benefit and increases the amount of the net single premium. The term "qualified additional benefits" includes, guaranteed insurability, accidental death or disability benefits, family term coverage and disability benefits,⁵ and other benefits as prescribed by Treasury Regulation.⁶

The second test has two components: the guideline premium and the cash value corridor test. The guideline premium component distinguishes between contracts where there is a traditional level of investment and those involving higher levels of investment. The policy meets these requirements if the sum of premiums paid does not exceed the greater of the guideline single premium or the sum of the guideline single premiums to date of determination.⁷ The

¹I.R.C. §7702(b).

²I.R.C. §7702(c).

³I.R.C. §7702(d).

⁴I.R.C. §7702(b)(2)(A).

⁵I.R.C. §7702(f)(5).

⁶I.R.C. §7702(f)(5)(v).

⁷I.R.C. §7702(c)(1).

guideline single premium is the premium required to fund the future benefits under the insurance contract.⁸ The guideline level premium is the level annual amount, payable over a period ending when the insured reaches age 95, that is necessary to fund future benefits under the insurance contract.⁹

The cash value corridor test disqualifies life insurance contracts that permit excessive cash value to build up. A life insurance contract fails this test if the death benefits at any time are equal to or greater than the applicable percentage of cash surrender value in the statutory table in I.R.C. Section 7702(d)(2).

If neither test is met, the contract will not qualify for life insurance treatment each year. The taxable income from the policy is equal to the increase in the contract's net surrender value, plus the cost of the life insurance provided, minus the premiums paid and the policyholder dividends received.¹⁰

This new definition of life insurance applies to life insurance contracts issued after December 31, 1984, unless one of three exceptions are met.¹¹ Also, if a life insurance contract issued after June 30, 1984 provides for increasing death benefits and has premium funding more rapid than ten year level premium payments, it will not qualify under the definition of life insurance.¹²

The first exception is if the life insurance contract is a flexible premium contract which provides for the payment of premiums which are not fixed by the insurance company as to time and amount.¹³ The second exception is for contracts which would meet the definition of a life insurance contract under Section 7702's cash value accumulation if a three instead of four percent interest rate were assumed and if the date of maturity were assumed to be twenty years from the date of issue or the day which the insured reaches age 95, whichever is earlier.¹⁴ The third exception is for insurance contracts whose premiums are adjusted, reflecting the level amount necessary to provide a level death benefit assuming a three percent annual interest rate.¹⁵

Life insurance contracts which are issued in exchange for contracts existing before January 1, 1985 will be considered as new contracts issued after December 31, 1984.¹⁶ A change in an existing contract is not considered an exchange of an existing contract if the amount of death benefits, the pattern of

⁸I.R.C. §7702(c)(3).

⁹I.R.C. §7702(c)(4).

¹⁰I.R.C. §7702(g)(B).

¹¹Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(d), 98 Stat. 772.

¹²Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(d)(2)(A), 98 Stat. 772.

¹³Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(d)(2)(B)(i), 98 Stat. 772.

¹⁴Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(d)(2)(B)(ii), 98 Stat. 772.

¹⁵Deficit Reduction Act of 1984, Pub. L. No. 98-369, §221(d)(2)(B)(iii), 98 Stat. 772.

¹⁶I.R.C. §7702(f)(7)(B).

these benefits, the pattern of premiums, and the rates guaranteed remain unchanged. Therefore, if minor changes are made in a life insurance contract which do not affect these, it will not be classified as a new insurance contract subject to the new rules.

Another area of change in the law affecting life insurance concerns group term life insurance. The Tax Reform Act of 1984 amended I.R.C. Section 79 which requires tax to be paid by former employees on the cost of their insurance coverage over \$50,000. Additionally, the Tax Reform Act attempted to cut down on the number of discriminatory group term life insurance plans by making the full amount of the cost of the life insurance which was paid by the employer, taxable to the employees. Also, the cost attributable to the employee cannot be determined under the uniform cost table, but rather it is includible on the basis of actual cost. Both of these provisions were added by Congress in order to equalize the treatment of all employees, both active and retired. These amendments are effective for years after December 31, 1983, but do not apply to plans which exist as of January 1, 1984 which have an individual who retires under that plan if that individual is 55 years old on or before January 1, 1984 and was employed at anytime during 1983, or retired from employment on or before January 1, 1984. Existing plans must conform by January 1, 1987, excluding coverage provided to employees retiring before January 1, 1987.¹⁷

¹⁷Deficit Reduction Act of 1984, Pub. L. No. 98-369, §223(d), 98 Stat. 775, 776.

S Corporation Changes in the Tax Reform Act of 1984

CLIFFORD L. DECAMP

There were many changes to the S corporation tax laws due the Tax Reform Act of 1984. Among these changes are three that were made to the accumulated adjustments account of S corporations. The accumulated adjustments account is an account of an S corporation used to compute the tax effect of distributions by the corporation when it has accumulated earnings and profits. The first change is that an S corporation's losses in a tax year may cause the accumulated adjustments account to be negative, creating a situation where the accumulated adjustments account will become zero or become positive only after the negative account balance has been replaced by income.¹ The second change was that nondeductible amounts which are not related to the production of income will be taken into account to reduce an S corporation's accumulated adjustments account.² The third change is the creation of a rule to apply where the S corporation has earnings and profits and the distributions exceed the balance in the accumulated adjustments account. The rule is that, except to the extent provided by regulations, the balance of the account will be allocated among the distributions in proportion to their size. This has the effect of requiring proration of the amount of each distribution during the year to determine how much is a dividend.³ All three of these changes to the accumulated adjustments account apply to tax years after 1982.

Another major change made to S corporation taxation, was to allow an election not to reduce the basis of its stock for all distributions during the post-termination transition period.⁴ This election allows the S corporation the opportunity to treat these distributions as dividends. This would most likely be done in order to avoid the accumulated earnings or personal holding company taxes. This can only be done if all the shareholders agree, and only applies to those corporations who have accumulated earnings and profits.⁵ Normally in a post-termination transition period, the distributions of money are nontaxable distributions which reduce the adjusted basis of the corporation stock to the extent of the accumulated adjustments account. If the election not to reduce the basis of stock is made, that distribution will be treated as a dividend to shareholders.⁶

Under past rules, when an S corporation becomes a C corporation during

¹I.R.C. §1368(e)(1)(A).

²*Id.*

³I.R.C. §1368(c).

⁴I.R.C. §1371(e)(2).

⁵*Id.*

⁶I.R.C. §1371(a).

its tax year, the tax year is divided into two short tax years with income and expenses allocated between the two. Now the corporation need not close its books on the termination date. All items of income, loss, deductions and credit can be allocated across the entire year, based on the number of days in each short tax year. An S corporation can still assign items of S and C corporation years by closing the books on termination of the S election, but only if all shareholders of both the S corporation and C corporation agree.⁷

In order to apply I.R.C. Section 338 in a consistent manner to S corporations who sell their stock to a C corporation, and to C corporations who sell their stock to another C corporation, Section 1362(e) was amended to allow the purchasing corporation to elect treatment of the acquisition of the stock of the target corporation as if it were the purchase of the target corporation's assets.⁸ This is done to avoid having to recapture items which flow through to the shareholder's individual returns and instead have them be reported by the purchasing corporation.

The 1984 Act also provides that if a debt owed by an S corporation to one of its shareholders becomes worthless, the losses that pass through to the shareholder are used first to reduce the shareholder's basis in the debt. This allows a shareholder to claim a deduction for losses based on this debt in the year that the corporation files bankruptcy.⁹

There were two amendments to other sections of the Code. The first of these was to amend Section 465(a)(1) to apply the at-risk rules to losses at the shareholder level rather than at the corporate level, thus treating the S corporation similar to partnerships. Also Section 267(f), which modified the general rule that an S corporation cannot deduct business expenses and interest owed to related parties, has been amended to permit a deduction for an item after it is paid and includible, if the item is deductible at some later time.

The Tax Reform Act of 1984 created a temporary rule permitting S corporation shareholders to treat income of the corporation as if received by the shareholder as investment income. This can be done for income which would be passed through to the shareholder by reason of their shareholder holdings, except to income attributable to personal services performed by a shareholder. This is designed to lessen the impact of the transition from the provisions of Subchapter S to the new provisions of S corporations.¹⁰

Section 1363(e) was added to the Internal Revenue Code in order to clarify situations where gain is not recognized by an S corporation on the distribution of appreciated property in complete liquidation when the distribu-

⁷I.R.C. §1362(e)(3).

⁸I.R.C. §1362(e)(6)(C).

⁹I.R.C. §1367(b)(3).

¹⁰Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 966.
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tion is done in respect to its stock.¹¹

Earnings and profits of S corporations are adjusted for taxes where the corporation is liable for the investment tax credit recapture. This applies to S corporations whose accumulated earnings and profits are reduced by the recapture of investment tax credit. This new rule is effective for years after December 31, 1982.¹²

The Tax Reform Act also made several changes to the requirements for S corporation status. S corporations are not treated as members of an affiliated group during a period, by reason of the ownership of stock of another corporation, if that corporation has not begun business and if the corporation does not have gross income. It eliminates the taxable income test to determine whether a subsidiary is inactive and replaces it with the gross income test. Thus, it prevents the inadvertent termination of the S corporation's S election which would go back to the beginning of the year in which the acquisition occurs, by reason of the subsidiary having taxable income.¹³ Additionally, under I.R.C. Section 1363(b)(4), added to the Code, the corporate preference rules of I.R.C. Section 291 apply to S corporations as well as C corporations for any three years preceding that year.

¹¹I.R.C. §1363(e).

¹²I.R.C. §1371(d)(3).

¹³I.R.C. §1361(c).

Partnership Changes in the 1984 Act

MARK GIANCARLI

The partnership utilizes the pass-through method of taxation and has been used as a tax shelter. The 1984 Tax Reform Act¹ (Act) addresses itself to some of the abusive tactics in the partnership area, which are as follows:

(1) After March 31, 1984, for property contributed to a partnership by a partner, income, gain, loss and deductions must be shared among partners pursuant to IRS regulations to take into account the variation between the partnership's adjusted basis in the property and its fair market value at the time it was contributed.²

(2) As a rule, a partner's share of distributive share items is to be determined by taking into account his varying interests in the partnership during the tax year in order to prevent the retroactive allocation of deductible expenses to partners entering a partnership late in the year. The Act specifically provides that the determination of the distributive share be made using a method prescribed in the regulations.³

(3) The Act changes the treatment of payments to partners for services performed for, or property transferred to a partnership. These changes are designed to eliminate disguised payments for services or property and disguised sales.⁴

(4) In order to prevent the conversion of capital losses into ordinary losses or the conversion of ordinary income into capital gains by contributing property to a partnership and even contributions of unrealized receivables, inventory items, and capital loss property, the Act provides rules that require the partnership to recognize income or loss on any disposition of certain contributed property based on the character of the assets in the hands of the contributing partner.⁵

(5) After March 31, 1984, if a corporation distributes an interest in a partnership, the amount and character of the gain recognized by the corporation will be computed by treating the distribution as if it included a property distribution consisting of the corporation's proportionate share of such partnership property.⁶

¹Deficit Reduction Act of 1984, Pub. L. No. 98-369.

²Act Section 71, amending Code Sections 613A(c)(7)(D), 704(c), and 743(b).

³Act Section 72, amending Code Section 706.

⁴Act Section 73, amending Code Section 707(a).

⁵Act Section 74, adding Code Section 724 and amending Code Section 735.

⁶Act Section 75, adding Code Section 386, and amending Code 761 and 7701.

(6) After March 31, 1984, for distributions, sales, and exchanges, a partnership that owns an interest in another partnership will be treated as owning its proportionate share of the property of the other partnership for purposes of determining whether the property of the first partnership is an unrealized receivable or an inventory item under Code Section 751.⁷

(7) After March 31, 1984, the nonrecognition of gain or loss rules for like-kind exchanges will not apply to exchanges of partnership interests. The Act imposes a special 180-day time limit on the completion of like-kind exchanges and requires the property to be received in the exchange to be identified within 45 days after the date of the original property transfer.⁸

(8) After March 31, 1984, a partnership is prohibited from increasing the adjusted basis of remaining partnership property under Code Section 734(b)(1)(B) following a distribution of partnership property which is an interest in another partnership if the second partnership has not also made the Code Section 754 election to adjust the basis of partnership assets upon distribution of property and upon the transfer of a partnership interest. In other words, to receive a step-up in basis of partnership assets, related partnerships must make consistent Code Section 754 elections.⁹

(9) The *Raphan* case¹⁰ holds that a general partner who guaranteed an otherwise nonrecourse debt of the partnership was not to be treated as personally liable with respect to that debt and that the limited partners were entitled to include a portion of the nonrecourse debt in computing the basis of their partnership interests. However, the new regulations are expected to follow the position in Rev. Rul. 83-151¹¹ that only the general partner's basis is increased to the extent of the nonrecourse liability.

⁷Act Section 76, adding Code Section 751(f).

⁸Act Section 77, amending Code Section 1031(a).

⁹Act Section 78, amending Code Section 734(b).

¹⁰*Raphan v. United States*, Cls. Ct., 83-2 USTC ¶ 9613, 3 Cls. Ct. 457 (1983).

¹¹1983-2 C.B. 105.

IRAs, SEPs and KEOGHs

JOHN LUCAS

Like other aspects of the Code, provisions effecting Individual Retirement Accounts (IRA's), Simplified Employee Pension Plans (SEP's), and Keoghs were changed by the 1984 Tax Reform Act. Although these changes may seem rather minor, it is very important that tax return preparers be aware of them .

Prior to 1985 the due date for contributions to IRA's could be extended by the extension of the individual's tax return. However, contributions after 1984 must be made by the unextended due date of the tax return.¹

Beginning in 1985 alimony is treated as compensation for purposes of calculating the IRA deduction limit. This provision eliminates the restriction on divorced individuals who had previously contributed to an IRA under the spousal IRA rules.²

Another change effecting IRA rules deals with plan trustees and requires that IRA contributions be reported to the IRS and state to which taxable year a particular contribution relates. Failure to file such report will cause a penalty to the trustee which increases from \$10 to \$50 for a second offense.³

Under the Act, an amount is not required to be distributed under the usual rules for IRA's or qualified plans to the extent that amounts are held by an insurer that, on March 15, 1984, is engaged in a rehabilitation proceeding under applicable state insurance laws.⁴

The Act also repealed the estate tax exclusion for qualified plans and IRA benefits, in non-community property states. Generally, however individuals who have received benefits prior to 1985 and who irrevocably designate the form of their benefits before the enactment may qualify for the \$100,000 exclusion, just as those who met those requirements before 1983 qualified for the unlimited estate tax exclusion which existed prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).⁵

Limits on employee deduction for employer contribution made to SEPs are increased to match the \$20,000 limit on annual addition to qualified defined contribution plans. This increased employee deduction is effective for tax years beginning after 1983.⁶ If the employer does not maintain an integrated

¹Act §147(c), *amending* I.R.C. §219(f)(3)(A); Act §147(d).

²Act §529, *deleting* I.R.C. §219(b)(4) and *amending* I.R.C. §219(f)(1).

³Act. §147(a), (b), and (d) *amending* I.R.C. §408(i) and §6693(a).

⁴Defecit Reduction Act of 1984. Pub. L. No. 98-369, 98 Stat. 966 §553.

⁵*Amending* I.R.C. §§2039(e), 2039(g).

⁶Act. Sec. 713(d)(2), *amending* I.R.C. §219(b)(2)(A)(ii).

plan during the taxable year, OASDI contributions may be taken into account as contributions by the employer to the employee's SEP, if OASDI contributions are taken into account with respect to each employee maintaining an SEP. The rules for OASDI contributions to SEP apply contributions to SEP's made on behalf of a self-employed individual.⁷

The Tax Reform Act of 1984, following the lead set by TEFRA, repealed a number of special deductions for contributions to a Keogh, which are as follows:

(1) The rule relating to the return of excess contributions made on behalf of an owner-employee before the due date of the annual income tax return;

(2) The special exception to the excess contribution rules for contributions by an employer on behalf of an owner-employee to pay premiums for an annuity, endowment of life insurance contract on the life of the owner-employee issued under a Keogh plan;

(3) The requirement that limitations on deductions for a defined contribution plan must be computed separately with respect to (a) contributions on behalf of owner-employees and nonowner-employee partners, and (b) contributions on behalf of the common-law employees;

(4) The requirement that the special deduction limitations for self-employed individuals and S corporation shareholder-employees be reduced by any SEP employer contributions made on their behalf; and

(5) The rule that contributions on behalf of an owner-employee for level-premium insurance contracts can exceed 25 percent of compensation limit on contributions to a defined contribution plan.

Section 404(a)(8)(D) was changed to clarify that compensation in the case of a self-employed individual is a reference to earned income of such individual, without regard to the deduction allowable for a contribution to a qualified plan, which is derived from the trade or business under which a plan is established. The TEFRA earned income definition from Section 401(c)(2)(r) is unchanged, and is computed taking into account amounts contributed by the employer to a Keogh plan to the extent a deduction is allowed for the contribution. These changes are effective for tax years beginning after 1983.⁸

⁷Act. §713(j), *amending* I.R.C. §408(k)(3)(D).

⁸Act §713(d), *amending* I.R.C. §§404(a)(8)(D), 404(e), 415(c)(6)(C), and 415(e)(3)(B)(ii)(II), *repealing* I.R.C. §§72(m)(9), 401(e), 404(a)(9), 404(h)(4), and 415(c)(7).

Alimony and the Alimony Trust in 1985

JEANNE BITONTE

The Tax Reform Act of 1984 (TRA) effected a new definition of alimony. I.R.C. Section 71 currently provides that payments will qualify as alimony if they are:

- 1) in cash;
- 2) made under a divorce or separation agreement;
- 3) not between members of the same household;
- 4) not to extend beyond the death of the payee spouse;
- 5) not between spouses who file a joint return; and
- 6) if in excess of \$10,000 in any calendar year, extend for at least six years. If either spouse dies or payee spouse remarries, then the payments may terminate before six years.¹

TRA eliminates the rule that alimony payments had to continue for ten years, regardless of the amount.

TRA did not change the income tax treatment of alimony. The payee spouse continues to include the payment in his/her gross income and the payor spouse may deduct the amount of the payment.² However, case law suggests that the payor spouse may not deduct rehabilitation alimony, but the payee spouse must include it in his/her gross income.

TRA added Sections 215(c) and 6676(c) to the Code. Section 215(c)(1) requires that any recipient of alimony must furnish the payor with the recipient's taxpayer identification number (TIN). Section 215(c)(2) requires the payor to include the recipient's TIN on the payor's federal tax return in the year the payments are made. Section 6676 states that the Internal Revenue Service will assess a \$50 penalty against any party who fails to comply with Section 215(c)(10) and (2) unless the party can show reasonable cause for non-compliance.³

An alimony trust continues to be an available means to satisfy an alimony obligation. Before TRA either Section 71 or 682 of the Code governed the trust, depending on whether the trust was established before the divorce or incident to it. It appears that after TRA, Section 682 primarily governs the alimony trust because Section 71 does not contain the references to trust as it did before TRA. Accordingly, as before TRA the payee spouse must include payment from the trust in his/her gross income. However, the payor probably will

¹I.R.C. §71 (1985) amending I.R.C. §71 (1984).

²I.R.C. §215(a) (1985).

³I.R.C. §§215 and 6676.

not be entitled to a deduction as he would if he/she had paid alimony outright.⁴

An important tax planning consideration is the potential for capital gains and losses on property transferred to the trust. In *United States v. Davis*,⁵ the Supreme Court held that it was a taxable event when one spouse transferred property to another spouse pursuant to a divorce. The transferor was taxed on the difference between his/her adjusted basis and the fair market value of the property.⁶ TRA adds Section 1041 providing that no gain or loss will be recognized on the transfer of property either 1) between spouses or 2) between former spouses if related to the divorce. The transferee spouse takes the transferor's adjusted basis and will recognize gain or loss *upon the sale* of the property. The transferee tacks on the transferor's holding period to his/her own and is taxed accordingly.⁷

When one party transfers property to another and it *appears* that the transferee gave nothing of value to the transferor, gift tax is an important consideration. Before TRA, there were three ways that a transferee could avoid gift tax: the support exception, the decree exception, and the two year exception.⁸ After TRA if divorce occurs within three years, the transferor will pay no gift tax on the transfer.⁹ Since there will eventually be a divorce decree and consequently support rights relinquished, it appears that three pre-TRA exceptions have become one.

Estate tax consequences are another important tax planning consideration. Generally, a property transfer in release of support rights is an exchange for adequate consideration and, therefore, is not included in the transferor's gross estate. In *Harris v. Commissioner*,¹⁰ the Supreme Court added that there was adequate consideration to avoid inclusion in the gross estate only if there was a transfer pursuant to a divorce decree. To avoid gift tax, the parties must have a decree within three years of a property transfer. Furthermore, after TRA the focus is on Section 682 to determine the tax consequences of an alimony trust. Before TRA, a Section 682 trust would not have been included in the transferor's gross estate unless it fell within Section 2014.¹¹ After TRA, since Section 682 governs alimony trusts, the same rule may apply for 1985.

In addition, pre-TRA case law held that property settlement payments

⁴Seago and O'Neil, *New Law Substantially Changes Treatment of Alimony and Property Transfers at Divorce*, 61 J. TAX'N 202, 205 (1984) [hereinafter cited Seago and O'Neil].

⁵370 U.S. 65 (1962).

⁶Seago and O'Neil *supra* note 4, at 202.

⁷I.R.C. §1041 (1985).

⁸Sharfstein and Wallach, *Tax Consequences of Divorce: Current Law/Proposed Changes*, 123 Trust & Estates, 23, 26-27 (April 1984).

⁹I.R.C. §2516 (1985) amending §2516 (1984).

¹⁰340 U.S. 106 (1950).

¹¹Estate of Statz v. Comm'r, 78 T.C. 1172 (1982).

after death were deductible for federal estate tax (FET) purposes only if made pursuant to a court order. Payments made under a settlement agreement did not satisfy the court order doctrine.¹² TRA allows a FET deduction made pursuant to a property settlement because Code Section 2043(b) states that divorce property settlements constitute adequate consideration for FET purposes.¹³

The area of alimony and alimony trusts have changed drastically with TRA. Commentators conclude that the law in this area needs clarification. Until the law is clarified taxpayers should try to avoid possible undesirable tax consequences by providing for them in a written agreement.¹⁴

¹²Fink, *Income, Gift, and Estate Tax Aspects of Alimony Trusts*, 119 *Trusts & Estates*, 54, 57-58 (March 1980).

¹³I.R.C. §2043 (1985).

¹⁴Seago and O'Neil, *supra* note 4, at 208.

Tax Shelters Under the Tax Reform Act of 1984

JOHN LUCAS

Internal Revenue Service efforts to curb abusive tax shelters received a boost from the passage of the Tax Reform Act of 1984. Prior to this Act there were no requirements that tax shelters be registered. The Act requires organizers to register any investment offerings expected to generate specific levels of tax benefits and meet other investment criteria.¹

Tax shelters are now required to be registered by filing Form 8264, Application for Registration of a Tax Shelter², with the Service not later than the day on which the first offering for sale of any interest in the investment is made.³ Registration is required to include: (1) information identifying and describing the tax shelter; (2) information describing the tax benefits of the shelter; and (3) such other information as may be required by regulation⁴.

Upon filing, the Service will assign a registration number to each tax shelter. The seller or transferor is required to furnish the registration number to all investors⁵. This information is to be passed through a written statement.⁶ The investors are required to disclose this number on their returns when tax effects from the investment are recognized⁷. Reporting by the investor is accomplished on Form 8271, Investor Reporting of Tax Shelter Registration Number.⁸ Noncompliance with any of these requirements can result in penalties to the organizer,⁹ the seller,¹⁰ and the investor.¹¹

The individual or group primarily responsible for organizing the tax shelter has primary responsibility for complying with the registration requirement¹². Secondary responsibility falls on individuals participating in the organization, management, and sale of the investment, in that order.¹³

An investment will generally be required to be registered if it meets two criteria. First, if it may be reasonably anticipated that the ratio of tax benefits (deductions plus two hundred percent of the tax credits) potentially derived

¹I.R.C. §6111.

²Temp. Reg. §301-6111-1t (question 47) (1984).

³I.R.C. §6111(a)(1).

⁴I.R.C. §6111(a)(2).

⁵I.R.C. §6111(b).

⁶Temp. Reg. §301-6111-1t (question 53) (1984).

⁷I.R.C. §6111(b)(2).

⁸Temp. Reg. §301-6111-1t (question 53) (1984).

⁹I.R.C. §6707(a).

¹⁰I.R.C. §6707(b)(1).

¹¹I.R.C. §6707(b)(2).

¹²Temp. Reg. §301-6111-1t (question 26) (1984).

¹³*Id.*

from the investment, to amounts invested by any investor (cumulative amount of cash plus the adjusted basis of other property, less any liability to which the property is subject) will be greater than two-for-one.¹⁴ Second, the investment must fall under any of the following categories: (1) it is required to be registered under federal or state security laws; (2) it is sold under a federal or state securities exemption which requires that notice be filed; or (3) it is a substantial investment¹⁵, which means the aggregate amount that may be offered for sale to all investors exceeds \$250,000, and five or more investors are expected.¹⁶

The Secretary has been empowered to make exemptions to the registration requirements.¹⁷ Generally there are three such exemptions: (1) investment in a principal place of residence by the purchaser; (2) sales or leases of tangible personal property by the manufacturers to be used in the trade or business of the purchaser; and (3) any other investment specified by the Secretary in a rule-related notice published in the Federal Register.¹⁸

Registration of a tax shelter is not an indication that the Service has reviewed, examined, or approved the tax shelter or claimed tax benefits.¹⁹ Instead the Act provides a uniform method of assimilating information which allows the Service to identify participants, and keep track of potentially abusive transactions in tax shelters. Whereas previously the Service had to search for this information, the Act requires taxpayers to accumulate this information and submit it to the Service.

When depreciation expense, interest deductions, and investment credits are considered it becomes obvious that virtually any business investment that is financed will meet the first criteria of being a tax shelter. Therefore prior to offering an investment for sale, an organizer should know that if the investment meets any of the second criterion, and does not fall under an exemption, the investment must be registered as a tax shelter.

¹⁴I.R.C. §6111(c)(1)(A).

¹⁵I.R.C. §6111(c)(1)(B).

¹⁶I.R.C. §6111(c)(4).

¹⁷I.R.C. §6111(e)(3).

¹⁸Temp. Reg. §301-6111-1t (question 24) (1984).

¹⁹Temp. Reg. §301-6111-1t (question 3) (1984).

Employee Stock Ownership Plans

DAVID DEVANY

The 1984 Tax Reform Act made several major changes concerning the tax consequences of an Employee Stock Ownership Plan (ESOP). The most important changes are: a tax-free rollover on the sale of "qualified securities" to an ESOP,¹ the deduction for dividends paid on ESOP stock², and a partial exclusion by the lender of interest earned on ESOP loans³. These changes are aimed at encouraging the implementation of ESOP's by making them more beneficial to the corporation and the lending institution.

Under the Act, a seller, even if a key shareholder, may elect non-recognition of gain from the sale of certain "qualified securities" if (1) the securities are sold to an ESOP on an eligible farmer-owned cooperative,⁴ and (2) within a "qualified period," the seller acquires replacement securities of a domestic corporation. In order for there to be non-recognition, the ESOP must, after the sale, own at least 30 percent of the total value of the currently outstanding employer securities. Qualified securities are those employer securities issued by a domestic corporation which have been held by the seller for at least one year, and which were not received by the seller as a distribution from a qualified plan. The qualified period referred to above begins three months before the date of the sale and ends twelve months after that date. The seller's basis in the replacement securities is reduced by the amount of non-recognized gain. It is important to note that this non-recognition provision requires the seller to make an election no later than the seller's income tax return date.

A second major change made by the Act is that now an employer corporation is allowed a deduction for dividends paid on ESOP stock. The deduction is allowed if the dividends are paid in cash directly to plan participants or are paid to the plan and distributed in cash no later than 90 days after the close of the plan's tax year. This is a major variance from the general rules of non-deductibility of dividends by the corporation. However, the benefits of this new rule are partially offset by the fact that these dividends are not eligible for the partial exclusion of dividends received by individuals.

Finally, under the Act, a bank or any commercial lender can now exclude from its income 50 percent of the interest received on loans to an ESOP or to a corporation to be used for the benefit of an ESOP. The purpose of this provision is to encourage lending institutions to loan money to an ESOP. Lending institutions have finite amounts of funds available and this provision makes it

¹I.R.C. §1042.

²I.R.C. §§116(e), 404(k), and 3405(d)(1)(B)(iii).

³I.R.C. §133.

⁴I.R.C. §1381.

cost beneficial to prefer an ESOP over other borrowers.

The Act also establishes an excise tax which can be imposed if within three years after an ESOP acquired qualified securities in a non-recognition transaction, the ESOP disposes of the securities and the total number of shares held by the plan after the disposition is less than the total number of employer securities held immediately after the sale on the plan and the ESOP owns less than 30 percent of the value of the currently outstanding employer securities. The excise tax will be ten percent of the amount realized on the disposition. However, the tax will not be imposed if the disposition is made due to a participant's death, disability, separation from service or retirement.

The foregoing rules are evidence of congressional encouragement of ESOP's and employer-owned corporations. These rules encourage a corporation to use an ESOP in order to get the dividend deduction and they encourage a bank to loan money to an ESOP to utilize the interest exclusion. Furthermore, once an ESOP obtains ownership of a significant portion of employer securities, the new rules attempt to protect this ownership interest by imposing an excise tax on certain dispositions. From these new provisions, it is evident that Congress favors ESOP's and intends to promote than in any way that it can.

C Reorganization Changes

STEVEN A. DIMENGO

The Tax Reform Act of 1984¹ modified the statutory requirements for qualification as a "C" reorganization. The general requirements under I.R.C. Section 368 (a)(1)(C) have not been changed. A "C" reorganization still basically involves the acquisition by one corporation of substantially all of the assets of another, transferor corporation in exchange for voting stock of the acquiring corporation.² However, for transactions pursuant to plans adopted after July 18, 1984, the acquired corporation must distribute the stock or other property it receives in pursuance of the plan of reorganization.³

The Secretary may waive the additional distribution requirement to transactions meeting any prescribed conditions.⁴ The Conference Committee Report states that waivers should be granted where the distribution would result in substantial hardship.⁵ However, the report also states that the waiver should be granted only if the acquired corporation and its shareholders act as if the retained assets had been distributed and contributed to the capital of a new corporation.⁶

Section 312 was also amended to allow the Secretary to prescribe regulations whereby the earnings and profits of the acquired corporation in a "C" or "D" reorganization are to be allocated between the acquiring corporation and the acquired corporation.⁷ The Conference Committee Report anticipates that such allocations would enable there to be similar tax consequences for both an "A" reorganization (e.g. a merger) preceded by a distribution, and a "C" reorganization followed by a distribution.⁸

The Senate Committee Report notes that "C" reorganizations were originally designed to cover acquisitive transactions resembling statutory mergers or consolidations whereby the acquired corporation is liquidated.⁹ However, before the Tax Reform Act of 1984, transactions could qualify as "C" reorganizations without a distribution of the acquired corporations assets.¹⁰

¹Tax Reform Act of 1984, Pub.L.No. 98-369, 98 Stat. 494.

²I.R.C. §368(a)(1)(C).

³I.R.C. §368(a)(2)(G)(i).

⁴I.R.C. §368(a)(2)(G)(iii).

⁵H.R. CONF.REP. 4170, 98th Cong., 2d Sess., *reprinted in The Tax Reform Act of 1984, Tax MGMT* (BNA) B-284.

⁶*Id.*

⁷I.R.C. §312(h)(2).

⁸H.R. CONF. REP. 4170 98th Cong., 2d sess., *reprinted in The Tax Reform Act of 1984, TAX MGMT* (BNA) B-284.

⁹J.COMM. ON TAX'N 98th Cong., 2d sess. (1984) (Comm. Print 1984), *reprinted in GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984*. (P-H) 189.

¹⁰*Id.*

Accordingly, the acquired corporation could remain active and defeat the original intent of the "C" reorganization provision.¹¹ Since tax attribution, such as earnings and profits, carryover to the acquiring corporation, the acquired corporation would have no tax attributes.¹² Sections 368 (a) and 312(h) were amended to erase these opportunities for tax avoidance.¹³

¹¹*Id.*

¹²*Id.*

¹³*Id.*

Employee Leasing

WENDALL STOCKER

The Tax Equity and Fiscal Responsibility Act of 1982, TEFRA, added Section 414(n)¹ to the Internal Revenue Code. This new section became effective January 1, 1984 and involves employee leasing provisions as they relate to qualified retirement plans. Generally, under Section 414(n), a person or entity receiving services (herein referred to as the "recipient") from a leased individual must consider that individual as an employee for purposes of certain employee benefit provisions. This occurs even though the individual is a common law employee of a leasing organization. In effect, the purpose of this new section is to include these leased employees as actual employees when attempting to qualify a retirement plan. Prior to enactment of this section, an organization could avoid including such employees in its qualified plans simply by leasing their services.

In Notice 84-11², the Service advanced temporary rules which are authoritative in making any subsequent rulings until permanent regulations are issued. Under Code Section 414(n) and the rules of the Notice, an individual is deemed to be a "leased employee." The individual must, therefore, be considered a common law employee of the recipient for purposes of certain employee benefit provisions of the individual, although not an employee. In addition, the individual must meet three additional criteria.

The first additional criterion requires that the services be "provided pursuant to an agreement between the recipient and any other person (the "leasing organization").³ The Service does not make clear what constitutes the existence of a leasing organization but simply states that this determination will be made on a case by case basis.⁴ The agreement requirement is met if an oral contract exists,⁵ making a written agreement not necessary.

The second additional criterion requires that services be performed "on a substantially full time basis for a period of at least one year."⁶ There are two ways to meet this requirement. If, during any consecutive twelve month period, a person provides, either at least 1500 hours of service to the recipient or a number of hours of service which at least equals 75 percent of the average number of hours normally performed by a recipient employee in the same position, the individual is deemed to have performed services on a substantially

¹I.R.C. §414(n) (1982).

²Notice 84-11, 1984-29 I.R.B. 31.

³I.R.C. §414(n)(2)(A) (1982).

⁴Notice 84-11, 1984-29 I.R.B. 31.

⁵*Id.*

⁶I.R.C. §414(n)(2)(B) (1982).

full-time basis.⁷ Any service hours provided to an organization which is related to the recipient⁸ are included in this computation. Furthermore, the one year service period can be fulfilled prior to the January 1, 1984 effective date of Section 414(n), provided the services were performed on a substantially full time basis during that previous period.⁹

The third additional criterion requires that services be of "a type historically performed in the business field of the recipient by employees."¹⁰ This requirement is considered met if it is not unusual for employees of organizations in the same business field as the recipient to perform the services provided by the leased individual.¹¹ Only those individuals meeting all of the above criteria are deemed "leased employees" and therefore, covered by the Section 414(n) provisions.

Any individual deemed to be a "leased employee" of the recipient is considered a common law employee of the recipient for purposes of the following employee benefit provisions¹²: the exclusive benefit rule,¹³ minimum participation requirements,¹⁴ minimum vesting requirements,¹⁵ anti-discrimination requirements,¹⁶ limitations of contributions and benefits,¹⁷ simplified employee pensions rule,¹⁸ top-heavy plans provisions,¹⁹ and deductions for contributions.²⁰ Although leased employees are considered employees of the recipient for purposes of the above provisions, there is no provision requiring the inclusion of leased employees as participants in the recipients plan.²¹ Thus, provided the leased employees are treated as the recipient's employees for purposes of the above provisions and the plan otherwise qualifies under Section 401(a), the leased employees can be excluded from participation in the plan, either individually or as a class.²² However, recipients receiving services from leased employees must amend their existing qualified plans to specifically provide how the leased employees will be treated under the plans.²³

⁷Notice 84-11, 1984-29 I.R.B. 31.

⁸I.R.C. §414(n)(6) (1982) "Related persons" has the same meaning as used in Section 103(b)(6)(c).

⁹Notice 84-11, 1984-29 I.R.B. 31, 32.

¹⁰I.R.C. §414(n)(2)(C) (1982).

¹¹Notice 84-11, 1984-29 I.R.B. 31, 32.

¹²I.R.C. §414(n) (3) (1982), Notice 84-11, 1984-29 I.R.B. 31.

¹³I.R.C. §401(a) (1982) Inclusion of this requirement is found in the Notice but not in the Code.

¹⁴I.R.C. §401(a)(3) and 410 (1982).

¹⁵I.R.C. §§401(a)(7) and 411 (1982).

¹⁶I.R.C. §401(a)(4) (1982).

¹⁷I.R.C. §401(a)(6) and 415 (1982).

¹⁸I.R.C. §408(k) (1982).

¹⁹I.R.C. §416 (1982).

²⁰I.R.C. §404 (1982) This requirement is mentioned in the Notice but not the Code.

²¹Notice 84-11, 1984-29 I.R.B. 31, 32.

²²*Id.* at 33.

²³*Id.*

If a leased employee is included as a participant in a recipient's plan, the entire period the individual has provided services to the recipient, including periods prior to the January 1, 1984 effective date of Section 414(n), is taken into account for purposes of the participation and vesting requirements.²⁴ However, the recipient is not required to include the individual as a participant in its plan prior to January 1, 1984, even though, under the above rule, the participation and vesting requirements were fulfilled prior to that date. If included as a participant in the recipient's plan, contributions or benefits provided by the recipient on behalf of the leased employee, and based on compensation, are determined according to the total compensation received from the leasing organization attributable to the performance of services for the recipient.²⁵

Under Code Section 414(n)(5), the leased employees rules are not applicable to leased employees participating in a "safe harbor" plan maintained by the leasing organization.²⁶ A plan qualifies under this safe harbor exception if it provides full and immediate vesting, immediate participation,²⁷ and a nonintegrated contribution pension plan.²⁸ The leasing organization is not required to include all of its common law employees in the safe harbor plan provided the plan is an otherwise qualified plan, taking the excluded employees into account.²⁹ However, the general leasing provisions of Section 414(n) are then applicable to those leased employees excluded from the safe harbor plan.

²⁴*Id.* at 32.

²⁵*Id.* at 33.

²⁶I.R.C. §414(n)(5) (1982).

²⁷Notice 84-11, 1984-29 I.R.B. 31. Immediate participation need not occur prior to the January 1, 1984 effective date.

²⁸I.R.C. §414(n)(5)(A) (1982).

²⁹Notice 84-11, 1984-29 I.R.B. 31,33.

Deductibility of Compensable Claims Under Section 165

CHERLYN PHERIGO

On May 2, 1984, the Sixth Circuit, in *Miller v. Commissioner*¹ affirmed the Tax Court's holding that a taxpayer who voluntarily elects not to file an insurance claim for a casualty loss is not precluded from taking a casualty loss deduction under Code Section 165.² In so holding, the court expressly overruled its prior decision in *Kentucky Utilities Co. v. Glenn*³ to the extent that the opinions conflict.

The situation in *Miller* involved a boating accident where a friend of the taxpayer ran the taxpayer's boat aground, damaging the boat to the extent of \$842. The boat was insured, but the taxpayer chose not to pursue a claim for fear that it would result in the cancellation of his insurance policies.⁴ He collected \$200 from the friend and thereafter claimed a \$542 casualty loss deduction on his 1976 return.⁵ The Commissioner disallowed the deduction, and the taxpayer challenged that determination in the Tax Court. The Tax Court, in view of *Hills v. Commissioner*,⁶ allowed the deduction.

The Sixth Circuit, not being able to distinguish its case at bar from *Kentucky Utilities*, where the taxpayer/insured failed to pursue indemnification from its insurance carrier and was barred from taking any casualty loss deduction under the equivalent of Code Section 165 (a) except to the extent of its deductible, required an overruling of *Kentucky Utilities*.

The *Miller* opinion⁷ initially interpreted the holding in *Kentucky Utilities* to be: "either (a) that a taxpayer must exhaust all reasonable prospects for insurance indemnification before claiming a "sustained loss," or (b) that the phrase "not compensated by" must be equated with the phrase "not covered by" insurance."⁸

The first interpretation was rejected because the court found the language of Code Section 165(a) required a separation of the loss from the insurance consequences. Relying chiefly on *Hills*, the court decided that requiring ex-

¹733 F.2d 399 (6th Cir. 1984).

²All references to the Code are to the Internal Revenue Code of 1954.

³394 F.2d 631 (6th Cir. 1968).

⁴733 F.2d at 400. The evidence showed that the taxpayer had policies covering his car, boat, and apartment and had submitted a number of claims in the recent past. His broker had advised him that another claim would result in the cancellation of all the policies. *Id.* at n. 3.

⁵733 F.2d at 400. This takes into account the \$100.00 limitation under Code Section 165 (c)(3).

⁶76 T.C. 484 (1981), *aff'd*, 691 F.2d 997 (11th Cir. 1982). The case allowed a deduction for a theft loss covered by, but not claimed under, insurance.

⁷Interestingly, the majority opinion was written by Judge Wellford, who commented that it was "based substantially upon a proposed version by Judge Celebrezze, who was also on the panel in *Kentucky Utilities*." 733 F.2d at 400, n.1.

⁸733 F.2d at 402 (footnote omitted).

haustion of insurance indemnification “renders the ‘not compensated by’ clause mere surplusage”⁹ because “any time a loss is sustained it, by definition, would not be ‘compensated for by insurance.’”¹⁰ The majority believed the rule of statutory construction requiring the avoidance of superfluous words was controlling, and concluded that the taxpayer here sustained a loss during the taxable year under Code Section 165(a).

The second interpretation was likewise rejected because the *Miller* panel refused to hold that “not compensated by” means “not covered by” in interpreting Section 165.¹¹ Again relying on *Hills*, the majority looked to legislative history and the lack of support for the *Kentucky Utilities* opinion on this issue. The court concluded that the language of the statute was clear and, without resort to analogy, that the plain meaning must be adopted. The court noted that Congress intended that Section 165 be applied to “‘losses not compensated for by insurance or otherwise’ to avoid double compensation,” and it further expressed this intent in the regulations.¹² The panel noted the observation in *Hills* that “[t]he disposition the Commissioner favore[d] in this case would deny a Section 165 deduction any time a loss is covered by insurance.”¹³ The ultimate holding was that Section 165(a) allows a casualty loss deduction when 1) there is a loss, and 2) it is not compensated for by insurance or otherwise.¹⁴

The dissent was extended and strong,¹⁵ advocating adherence to the *Kentucky Utilities* holding on this issue. The dissent’s first reason was that the “taxpayer’s voluntary choice not to file an insurance claim . . . prevented a loss from being sustained under Section 165(a),”¹⁶ because they found the concepts of casualty and loss to be distinct. A casualty does not necessarily result in a loss. The loss in *Miller* was caused by the taxpayer’s failure to seek compensation, not by shipwreck, and thus was not deductible under the Code.¹⁷

The second reason for dissent was the belief that this transaction was not closed and complete as required by Treasury Regulation Section 1.165-1(b), because the taxpayer still had a valid claim against his insurer.¹⁸ The failure to exhaust reasonable prospects of recovery causes the loss to be not actually sustained.

⁹*Id.* at 400 (citing *Hills*, 691 F.2d at 1002).

¹⁰*Id.* citing 691 F.2d at 1001-1002.

¹¹*Id.* at 403.

¹²*Id.* at 403-404. Specific regulations cited were Treas. Reg. §§1.165-1(c)(4) and 1.165-1(d)(2)(i). *Id.*

¹³*Id.* at 404 citing 691 F.2d at 1000.

¹⁴*Id.* at 404 (quoting *Hills*, 691 F.2d at 1000).

¹⁵The panel was divided 6-5 in *Miller*.

¹⁶733 F.2d at 405 (Contie, J., dissenting) (footnote omitted).

¹⁷*Id.* at 406.

¹⁸*Id.* at 407.

Finally, the dissent was disturbed by the majority's position because it results in preferred tax treatment for business taxpayers who will be able to deduct "both their insurance premium costs and their unrecompensed casualty damages for which reasonable prospects of recovery exist."¹⁹

The decision in *Miller* should come as no real surprise. In view of the *Hills* decision in the Eleventh Circuit, it appears that more and more judges are convinced that the question of whether a loss is sustained should be resolved independently of any potential insurance consequences involved. This interpretation is supported by the fact that the House Ways and Means Committee originally suggested that Section 165 read "losses . . . not covered by insurance or otherwise and compensated for," but the Senate Finance Committee amended the section to say "losses . . . not compensated for by insurance or otherwise."²⁰ The fact that a loss is covered by insurance is apparently irrelevant, since the only concern of the Internal Revenue Service is that it was not compensated for.

Conversely, however, it must be noted that none of the cases herein discussed relate to the cases under Code Section 162, regarding trade or business expenses, which prohibit deduction if there exists a right of reimbursement.²¹

¹⁹*Id.* at 409.

²⁰This was recognized by *Hills*, 691 F.2d at 1000 and *Miller*, 733 F.2d at 403, citing J. Seidman, Seidman's LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961, 1018 (1938).

²¹See *Levy v. Comm'r.* 212 F.2d 552 (5th Cir. 1954); *Burnett v. Comm'r.* 356 F.2d 755 (5th Cir. 1966), *cert. denied*, 385 U.S. 832 (1966).

Code 338 Election Rules — Temporary Regulations Issued

MARK A. GIANCARLI

Code Section 338 was enacted by TEFRA to replace the repealed 334(b)(2) liquidation procedure. Code Section 338 allows a corporation (purchaser) to elect to treat a qualified purchase of another corporation (target) as an asset purchase.¹ If the election is made, the target is deemed to have sold all of its assets under a Section 337 12-month plan of complete liquidation. The election rules are set out in Treasury Regulation Sections 1.338-1T, 2T, and 3T. The Tax Reform Act of 1984 changes the Section 338 election rules significantly. The rule changes are effective retroactively where the acquisition date is after August 31, 1982. The result is that a Section 338 election may now be made by a purchaser that was formerly not eligible to make an election. On the other hand, a purchaser may be deemed to have made an election with respect to a certain target, whereby a tax return (or amended return) must be filed. The Internal Revenue Service issued temporary regulations on September 6, 1984 (amending and redesignating the Temporary Regulations issued on February 7, 1984) that deal with Section 338 elections. The highlights of those regulations are as follows.

1. The purchasing corporation is required to make a statement of the election on Form 8023. The statement must: (i) contain the name, address, and employer identification number of the purchasing corporation and the target, (ii) identify the election as a Section 338(g) election, (iii) specify the acquisition date for elections filed after May 8, 1984, (iv) state the election was not barred by the consistency requirement of Section 338(f)(2) for elections made after October 9, 1984, and (v) be signed by a person who states under penalties of perjury that he or she is authorized to make the election on behalf of the purchasing corporation.²

2. The purchasing corporation may elect under Section 338(g) only by filing, on or before the 15th day of the 9th month beginning after the month in which the acquisition date occurs (or, if after the 60th day, after the date of publication of Reg. Section 1.338 - 4T). Under pre-'84 Act' law, Section 338(g)(1) required elections to be filed within 75 days after the acquisition date. Since Reg. Section 1.338 - 4T has not yet been issued, the time within which to file the election is temporarily extended until 60 days after the date it is published.³

3. Reg. Section 1.338 - 2T(d)(3) was added to provide guidance as to when to treat acquisitions by several members of an affiliated group as made by one corporation under Section 338(h)(8). Accordingly, when the election is made,

¹I.R.C. §338 (1985).

²Treas. Reg. §1.338-1T(d).

³Treas. Reg. §1.338-1T(c).

the consistency rules of Section 338(f) are triggered, and all acquisitions of a target's stock by members of an affiliated group within the specified 12 - month period are aggregated, whereby, two or more corporations may file a single statement of elections that contains the required information⁴ for each member and is signed by an authorized person.⁵ Also, note that under Section 338(f), a purchasing corporation is barred from making an election with respect to a second target affiliate, if an election was not made with respect to the first target within the specified 12-month period. On the other hand, under Reg. Section 1.338 - 1T(c), a purchasing corporation will be deemed to have made a Section 338 election with respect to a second target affiliate, if the election was made for the first target affiliate.⁶

4. The target is to be immediately disaffiliated from the selling group before the sale, which occurs at the close of the acquisition date.⁷ The result is that the selling group is not permitted to use the tax attributes of the target, i.e., the nonrecognition of gain or loss. Also note that the ultimate tax burden is shifted to the purchasing corporation, i.e., target's tax liability resulting from depreciation or investment credit recapture.

5. Reg. Section 1.388 - 1T(h)(1) waives, upon a showing of reasonable cause, certain additions to tax that arise prior to the close of the 60th day after the date Reg. Section 1.388 - 4T is published.

6. The regulations⁸ contain transitional election rules, whereby an election with respect to an acquisition made after August 31, 1980, and before September 1, 1982, may be made if filed before September 17, 1984, showing the deemed sales date.

7. Finally, the regulations⁹ contain miscellaneous rules under Section 224 of TEFRA relating to LIFO recapture provisions of the Crude Oil Windfall Profit Tax Act of 1980. The LIFO recapture amount is now reduced by one-million dollars for a plan of liquidation adopted in 1982. Since an election was not available in 1982, a timely Section 338 election causes any election that could have been made in 1982 to be treated as if it were made in 1982 for purposes of the LIFO recapture.

The Service admits need for immediate guidance with respect to these temporary regulations and should hopefully issue additional rulings or regulations in 1985 to further explain the Section 338 election.

⁴Treas. Reg. §1.338-1T(d)(1)(i).

⁵Treas. Reg. §1.338-1T(d)(1)(v).

⁶Treas. Reg. §1.338-1T(c).

⁷Treas. Reg. §1.338-1T(f)(1).

⁸Treas. Reg. §1.338-2T.

⁹Treas. Reg. §1.338-3T.

Gross Income Inclusion: Appreciation of Restricted Stock Options

ANNETTE SKINNER

Under I.R.C. Section 83, an employee who purchases restricted stock options granted to him or her in connection with employment is required to either (a) include in gross income for the taxable year in which the restriction lapses, the stock's appreciation in value between the time of purchase and the time the restriction lapsed, or (b) elect to include in gross income, for the taxable year in which the stock is purchased, the excess of the fair market value on that date of purchase over the amount paid for the stock.¹ The Ninth Circuit Court of Appeals held in *Alves v. Commissioner*² that unless Section 83(b) is elected, Section 83(a) applies to all restricted stock that is transferred in connection with employment even if the taxpayer paid full fair market value.

In *Alves*, the taxpayer purchased 40,000 shares of common stock as part of an employment and stock purchase agreement with the employer company. Alves paid ten cents per share and the parties stipulated that that was the fair market value on the date of purchase. The company had an option to repurchase one-third of those shares if Alves left the company within five years and it could repurchase another third if he left within four years. The remaining one-third shares were unrestricted. Alves did not report, as ordinary income, the appreciation in the fair market value of six dollars per share.³ The five-year shares appreciated to \$3.43 per share. The Tax Court sustained the deficiency determination of the Commissioner.⁴

The taxpayer presented four basic arguments in appealing the deficiency determination. First, the taxpayer claimed that because he had paid fair market value on the date of the purchase the shares were issued as an *investment* (which would take the transaction out of Section 83) rather than "in connection with the performance of services."⁵ The Court of Appeals agreed that payment of fair market value is one factor to be considered in determining whether stock is purchased as an investment. However, it held that other factors compelled the finding that the stock was issued in connection with employment. The court considered the fact that Alves purchased the stock at the same time he signed his employment contract and that with only one exception, the company had issued stock only to its officers, directors, and employees.

Secondly, the taxpayer argued that Section 83(a) should not extend to pur-

¹I.R.C. §83 (1984).

²734 F.2d 478 (9th Cir. 1984).

³*Id.* at 480.

⁴79 T.C. 864, 879 (1982) *aff'd.* 734 F.2d 478 (9th Cir. 1984).

⁵*Id.* at 865.

chases for fair market value, claiming that "in connection with the performance of services" implies that the employee is receiving compensation and if fair market value is paid, there is no compensation. The court rebutted this argument by pointing out that no reference is made to "compensation" in Section 83. Furthermore, if Congress had intended that Section 83 apply only to restricted stock used to compensate employees, narrower language would have been used.⁶

The taxpayer's third argument revolved around the theory that Section 83(a) and (b) apply only to bargain purchases, requiring inclusion of the excess over the purchase price. The court held that Section 83 does not require a bargain element in a stock transaction for the transaction to be governed by Section 83. In fact, the Treasury Regulation specifically states: "[t]he fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does *not* preclude the use of the [83(b)] election."⁷

The taxpayer's final argument was that the affirmative election required by section 83(b) is "simply a trap for the unwary." The court unsympathetically observed that there are many tax laws which necessitate an affirmative election in order for a taxpayer to benefit from the various tax advantages.⁸

⁶*Id.* at 870.

⁷Treas. Reg. §1.83-2(a).

⁸79 T.C. at 873.

