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Federal Income Tax Developments: 1985

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FEDERAL INCOME TAX DEVELOPMENTS: 1983

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and

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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1983 is the eleventh in a series of articles published at The University of Akron. In keeping with the established format, the scope of this survey is limited to selected substantive developments in the field of income taxation.

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I. SUPREME COURT CASES

1. *Hillsboro National Bank* — Tax Benefit Rule

In *Hillsboro National Bank v. Commissioner*,¹ the United States Supreme Court determined the applicability of the tax benefit rule to I.R.C. Section 164(e) deductions. The tax benefit rule is a “judicially developed principle that allays some of the inflexibilities of the annual accounting system.”² The usual rule, which is set forth in Justice Blackmun’s dissent,

As applied to deductions, appears to be this: whenever a deduction is claimed, with tax benefit, in a taxpayer’s federal return for a particular tax year, but factual developments in a later tax year prove the deduction to have been asserted mistakenly in whole or in part, the deduction, or that part of it which the emerging facts demonstrate as excessive, is to be regarded as income to the taxpayer in the later tax year.³

In *Hillsboro*, a corporate bank was entitled to a deduction for its payment of ad valorem personal property taxes⁴ imposed on its shareholders pursuant to I.R.C. Section 164(e), which grants a corporation a deduction for taxes imposed on its shareholders but assumed by the corporations.⁵ Subsequent prohibition by Illinois of ad valorem personal property taxes resulted in refunds to the individual shareholders rather than the banking institution. The bank did not include the amount of the refunds as income on its federal tax return.⁶ The Commissioner of the Internal Revenue Service assessed a deficiency against the bank,⁷ contending that the refunds should have been included as income under the tax benefit rule.

The Tax Court held that the bank received “such a benefit from the refunds to its shareholders as to constitute a ‘recovery’ and for purposes of the tax benefit rule.”⁸ As such, the refunds must be included as taxable income of the bank. To hold otherwise would be to allow the bank a deduction for a dividend distribution. This holding was affirmed by the Seventh Circuit Court of Appeals.⁹

¹103 S. Ct. 1134(1983). The *Hillsboro* case was consolidated with *United States v. Bliss Dairy, Inc.* There, a closely held dairy corporation deducted on purchase the full cost of cattle feed, a substantial portion of which was still on hand at the end of the year. Two days into the next tax year, the dairy declared a plan of liquidation. The Supreme Court, in applying the same test as in *Hillsboro*, held the dairy was bound to include in income the amount of the unwarranted deduction despite the I.R.C. § 336 nonrecognition, since the liquidation was fundamentally inconsistent with the I.R.C. § 162 deduction for ordinary and necessary business expenses. *Id.* at 1150.

²*Id.* at 1140.

³*Id.* at 1164.

⁴Ad valorem taxes are taxes fixed in proportion to the value of the property to be charged. BALLENTINE’S LAW DICTIONARY 39 (3d ed. 1969).

⁵I.R.C. § 164(e) (1982).

⁶*Hillsboro*, 103 S. Ct. at 1138.

⁷*Id.*

⁸73 T.C. 61, 66 (1979).

⁹641 F.2d 529 (7th Cir. 1981).

In making its analysis, the Supreme Court considered the general rule that “unless a nonrecognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent¹⁰ with an earlier deduction.”¹¹ Since the purpose of the tax benefit rule is to approximate the results produced by a transactional rather than annual tax accounting system, “a court must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the involved deductions.”¹²

Applying these guidelines to the *Hillsboro* facts, the court held that even though the bank in effect made a deductible dividend, it was not required to recognize income. The Court concluded that the purpose of Section 164(e) was to provide relief for corporations making such payments and that the act of payment should be stressed rather than the ultimate use of the funds by the state. Since the corporation itself received no refund, the refund to shareholders was deemed a nonrecognition event.¹³ Since the “changed circumstances” were not fundamentally inconsistent with the purpose of I.R.C. Section 164(e), inclusion in income was not required.

The *Hillsboro* decision leaves the tax benefit rule soundly within judicial discretion. The court rejected objective approaches offered both by the bank (inclusion only where the taxpayer actually recovers the deduction) and the Commissioner (inclusion where events are in any way inconsistent with the deduction). Instead, the Court opted for a subjective, case-by-case approach that requires a review of the “purpose” of a deduction followed by an evaluation of whether changing circumstances are “fundamentally inconsistent” with that purpose. The Court’s approach thus leaves the tax benefit rule in a disturbingly unpredictable condition.

2. *Memphis Bank* — Taxation of U.S. Obligations

The U.S. Supreme Court in *Memphis Bank & Trust Company v. Garner*,¹ faced the issue of whether a Tennessee bank tax, which taxed income derived from federal obligations but not income from obligations of the State of Tennessee or its political subdivisions, violated the immunity of obligations of the United States from state and local taxation.

Tennessee law required every bank doing business in the State to pay 3 percent of net earnings to local governments.² Net earnings as defined by statute

¹⁰The Court defines an event as fundamentally inconsistent “only if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction.” *Hillsboro*, 103 S. Ct. 1134, 1146 (1983).

¹¹*Id.* at 1138.

¹²*Id.* at 1144.

¹³*Id.* at 1149.

¹103 S. Ct. 692 (1983).

²TENN. CODE ANN. § 67-751 (1976) (repealed 1983).

included income received by a bank on obligations of the United States and its instrumentalities, as well as interest on obligations of states other than Tennessee.³

Memphis Bank brought an action in state court to recover approximately \$57,000 in excise taxes paid on bank earnings for the years 1977 and 1978.⁴ The parties stipulated that the Bank's tax liability was based entirely on interest earned on various federal obligations and that if this interest were excluded from the computation, Memphis Bank would owe no taxes for the years in question.⁵

The trial court granted summary judgment for Memphis Bank on the ground that the Tennessee tax violated 31 U.S.C. Section 742, which provides for a broad exemption of federal obligations from state and local taxation.⁶ The Tennessee Supreme Court reversed noting the exceptions to tax immunity under the federal statute⁷ for a nondiscriminatory franchise tax or other non-property tax in lieu thereof.⁸

The U.S. Supreme Court found that in order to fall under either exception to the constitutional rule of tax immunity for federal obligations, the tax must be nondiscriminatory.⁹ The court then concluded that the Tennessee bank tax discriminates in favor of its own securities and against federal obligations, by excluding them from the tax base while including comparable federal obligations in the tax base.¹⁰

The position of the U.S. Supreme Court as reflected by this and other recent decisions is that a state may not impose a tax, the economic burden of which falls on the federal government, unless such tax is nondiscriminatory.¹¹ The significance of *Memphis Bank* is that the Supreme Court shed more light on what constitutes a nondiscriminatory tax. A state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations.¹² Although the court determined this to be impermissible discrimination, it did not foreclose the possibility that there might be other criteria used in the future to determine what is impermissible discrimination.

³TENN. CODE ANN. § 67-4-805 (1983).

⁴*Memphis Bank*, 103 S. Ct. at 694.

⁵*Id.* at 695.

⁶*Id.*

⁷*Memphis Bank & Trust Company v. Garner*, 624 S.W.2d 551 (1981).

⁸31 U.S.C.A. § 742 (1982).

⁹*Memphis Bank*, 103 S. Ct. at 696 n.6 (1983).

¹⁰*Id.* at 697.

¹¹*United States v. County of Fresno*, 429 U.S. 452, 459-462 (1977).

¹²*Memphis Bank*, 103 S. Ct. at 696 (1983).

3. *Tufts* — Realization and Nonrecourse Debt

The heart of the issue resolved in *Commissioner v. Tufts*,¹ concerns what is the amount realized by a taxpayer in sale that includes nonrecourse debt assumed by the purchaser. The Supreme Court held that the amount realized includes the full amount of the assumed nonrecourse debt regardless of the fair market value of the property transferred.²

In *Tufts*, a corporation and several individuals formed a general partnership to construct an apartment complex.³ The partnership obtained a loan of \$1,851,000 to cover the entire cost of the construction, but the partnership itself was not personally liable.⁴ The complex was built, but due to deteriorating economic conditions it was never fully occupied.⁵ Income generated from the complex was not enough to reduce the mortgage and after one year, each partner sold his partnership interest in the project, which had \$1,851,000 in nonrecourse liability and a fair market value of \$1,400,000.⁶ The purchaser also agreed to pay the partner's sale expenses up to \$250 and acquired the property subject to the nonrecourse liability.⁷

During the partnership's life, each partner individually claimed his share of losses incurred, reducing the partnership's basis in the property to \$1,455,740.⁸ Each partner had computed his basis to include his share of the entire \$1,851,000 mortgage. The partners did not, however, include the full amount of the nonrecourse liability in the amount realized upon the sale.⁹ Instead, each partner took a long term capital loss arguing that footnote thirty-seven of *Crane v. Commissioner*¹⁰ applied, and stating that nonrecourse liabilities should only be included in amounts realized to the extent of the fair market value of the property securing the indebtedness. The Commissioner denied the loss, asserting that the full amount of the nonrecourse liability was the amount realized on the sale and that each partner thus realized a taxable gain.¹¹ Authority for the Commissioner's holding was section 1001(b) of the Internal Revenue Code¹²

¹103 S. Ct. 1826 (1983).

²*Id.* at 1836.

³*Id.* at 1828.

⁴*Id.*

⁵*Id.* at 1828-29.

⁶*Id.* at 1829.

⁷*Id.*

⁸*Id.*

⁹*Id.*

¹⁰331 U.S. 1 (1947). Footnote 37 reads as follows:

Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not the case.

331 U.S. 1 at 14 n.37.

¹¹*Tufts*, 103 S. Ct. at 1829.

¹²*Id.*

and Treasury Regulation 1.1001-2(a)(1).¹³

In a suit for a refund, the Tax Court held that the fair market value was irrelevant and denied the refund because the amount realized included the full amount of the nonrecourse liability.¹⁴ The Fifth Circuit Court of Appeals reversed, holding that the amount realized on the disposition of nonrecourse liability was limited by the fair market value of the encumbered property.¹⁵ Although the Court of Appeals expressed concern about abusive tax shelters used solely for the purpose of obtaining large tax deductions without a substantial investment of personal funds, they felt that the solution did not lie in expanding the meaning of "amount realized."¹⁶

In reaching its decision to reverse the Fifth Circuit, the Supreme Court relied on the 1947 case of *Crane v. Commissioner*,¹⁷ and the 1978 case of *Millar v. Commissioner*.¹⁸ The taxpayer in *Crane* inherited an apartment building and lot subject to a mortgage which had a tax appraised value equal to the total amount of the encumbrance.¹⁹ Taxpayer operated the apartment building for the next seven years while taking deductions for taxes, operating expenses, and interest paid on the mortgage and reporting income on the rentals.²⁰ The taxpayer sold the property to a third party for cash and was completely discharged from the debt, even though the purchaser did not become personally liable for the debt.²¹ The value of the property exceeded the value of the mortgage.²² The Supreme Court held that the amount realized included the full amount of the mortgage liability discharged. The Court was concerned with the reality that an owner of property, mortgaged at a figure less than the fair market value, must treat the mortgage as his personal obligation.²³ The economic benefit to the seller is real and as substantial as if the mortgage was discharged, or as if personal debt had been assumed by another.²⁴

The *Tufts* Court reaffirmed its holding in *Crane* and concluded "that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred."²⁵ Nonrecourse loans are treated

¹³*Id.* at 1832-33.

¹⁴*Tufts v. Commissioner*, 70 T.C. 756, 769-70 (1978).

¹⁵*Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981) *reh'g denied* (1981), *cert. granted*, 456 U.S. 960 (1982).

¹⁶651 F.2d at 1060-61.

¹⁷331 U.S. 1 (1947).

¹⁸577 F.2d 212 (3rd Cir. 1978), *cert. denied*, 439 U.S. 1046 (1978).

¹⁹*Crane*, 331 U.S. at 3.

²⁰*Id.*

²¹*Id.*

²²*Id.* at 4.

²³*Id.* at 14.

²⁴*Id.* at 13.

²⁵*Tufts*, 103 S. Ct. at 1831.

as true loans.²⁶ “Nothing in either § 1001(b) or in the Court’s prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property.”²⁷ All footnote 37 did was to acknowledge “the limitations of that theory (economic benefit theory) when applied to a different set of facts.”²⁸

4. *Bob Jones University* — Denial of Tax Exempt Status for Racially Discriminatory Schools

Until 1970, private schools enjoyed tax-exempt status regardless of their racial admissions policies under section 501(c)(3) of the Internal Revenue Code (“the Code”).¹ In addition, the Internal Revenue Service granted taxable deductions for contributions to such schools under Section 170 of the Code.²

This tax-exempt status changed in July of 1970, when the IRS ruled that private schools which practice racial discrimination could no longer enjoy tax-exempt status under section 501(c)(3).³ The IRS also concluded that gifts to such schools could not be treated as charitable deductions for income tax purposes under section 170.⁴ Private schools were formally notified of this change in policy by the IRS in a letter dated November 30, 1970.⁵

Bob Jones University (“Bob Jones” or “University”) and Goldsboro Christian Schools (“Goldsboro” or “School”) are two schools that practice racially discriminatory admissions policies. In a consolidated action before the United States Supreme Court, the schools challenged the IRS’ amended construction of the tax Code.⁶ The petitioners argued that the IRS’ interpretation of the Code and its resulting actions constituted “legislating” and as such, violated the right of religious schools to exercise freely their religious tenets.⁷

²⁶*Id.*

²⁷*Id.* at 1834.

²⁸*Id.*

¹I.R.C. § 501(c)(3) (1976). Section 501(c)(3) exempts the following organizations from taxation: “Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition. . . .” *Id.*

²I.R.C. § 170 (1976). Section 170(a) allows deductions for “charitable contributions.” Section 170(c) provides in pertinent part:

(c) Charitable contributions defined. For purposes of this section, the term “charitable contribution” means a contribution or gift to or for the use of . . .

(2) A corporation, trust, or community chest fund, or foundation . . .

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, . . . or for the prevention of cruelty to children or animals . . .

Id.

³Rev. Rul. 71-447, 1971-2 C.B. 230.

⁴*Id.*

⁵*Id.*

⁶*Bob Jones University v. U.S.*, 103 S. Ct. 2017 (1983).

⁷*Id.* at 2031.

Historically, charities have occupied a protected position in our community. As early as 1861 the United States Supreme Court announced that the “courts of chancery will sustain and protect . . . a gift . . . to public charitable uses, provided the same is consistent with local laws and public policy. . . .”⁸ Since 1894, the federal income tax laws⁹ have provided an exemption for certain charitable organizations¹⁰ because they serve desirable public purposes.

Bob Jones and Goldsboro argued that sections 501(c)(3) and 170 of the Code make any “charitable, religious or educational” organization tax-exempt regardless of its racial policies.¹¹ Although the Code does not explicitly mention racial discrimination, the Supreme Court analyzed sections 170 and 501(c)(3) and concluded that inherent in the Code is the intent that tax exemption depends on meeting “common law standards of charity.”¹² This means that before an institution can attain tax-exempt status it must serve a public purpose and not be contrary to public policy.¹³ Thus, religious and educational entities which violate public policy are not charitable and as such cannot be tax-exempt.

Since *Brown v. Board of Education*¹⁴ it has become clear that racial discrimination in education is contrary to established public policy. The *Brown* holding is not limited to public education. In *Norwood v. Harrison*,¹⁵ the Supreme Court held that free textbooks are a form of tangible financial assistance benefiting public and private schools and as such cannot be provided to any school that practices racial discrimination.¹⁶

Racial discrimination in private education was also addressed in *Runyon v. McCrary*.¹⁷ *Runyon* involved a civil rights action by parents of black children who were denied admission to private schools solely on the basis of race. In construing 42 U.S.C. § 1981,¹⁸ the Supreme Court held that racial discrimination in admissions to private, nonsectarian schools is unlawful.¹⁹

⁸*Id.* at 2027 (quoting *Perin v. Carey*, 24 How. 465, 501 (1861)).

⁹Act of August 27, 1894, ch. 349, § 32, 28 Stat. 509, 556-557 (1894).

¹⁰A common law definition of charity is found in *Ould v. Washington Hospital for Foundlings*, 95 U.S. 303 (1877): “A charitable use, where neither law nor public policy forbids, may be applied to almost any thing that tends to promote the well-doing and well-being of social man.” *Id.* at 311. See also RESTATEMENT (SECOND) OF TRUSTS § 374 comment f at 258 (1959); and Simon, *The Tax-Exempt Status of Racially Discriminatory Religious Schools*, 36 TAX. L. REV. 477, 483-500 (1981).

¹¹*Bob Jones*, 103 S. Ct. at 2025.

¹²*Id.* at 2026.

¹³*Id.*

¹⁴347 U.S. 483 (1954).

¹⁵413 U.S. 455 (1973).

¹⁶*Id.* at 469.

¹⁷427 U.S. 160 (1976).

¹⁸42 U.S.C. § 1981 (1976) provides: “All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and to enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws . . . as is enjoyed by white citizens” *Id.*

¹⁹427 U.S. 160 (1976).

In light of these decisions it is evident that the racially discriminatory admissions policy of Bob Jones University and Goldsboro Christian Schools neither furthers an established public policy nor confers a public benefit. This is so even though the schools' policies are based upon a sincere religious belief.²⁰

Even if the IRS was correct in concluding that racial discrimination in private schools violates public policy, Goldsboro and Bob Jones argued that the IRS did not have the authority to issue its 1970 and 1971 rulings. Both institutions alleged that the IRS "legislated" for Congress because the rulings altered the scope of the Code.²¹

Although not specifically mandated, the power of the IRS to construe the Internal Revenue Code has been sanctioned by the Supreme Court in a long line of precedents.²² Chief Justice Burger, writing for the majority, noted that these precedents illustrate that the IRS has the duty to determine whether a particular organization is "charitable" for the purpose of sections 170 and 501(c)(3).²³ Burger concluded that coupled with this duty is the authority of the IRS to determine whether an organization's activities are so contrary to public policy that it is unable to provide a public benefit worthy of tax-exempt status.²⁴

By denying tax-exempt status to schools that practice racially discriminatory admission policies, the IRS hopes to further a national goal of nondiscrimination in all areas. Although this may significantly impair future contributions to such schools, denial of tax exemption may not be an unduly harsh penalty, and it is unlikely that schools such as Bob Jones and Goldsboro will be forced to close their doors.

Although the courts should discourage nonlegislative bodies from legislating, they cannot prevent the IRS from interpreting the tax laws. The IRS successfully avoided the frustration of established federal policies by its interpretation of sections 501(c)(3) and 170. The *Bob Jones* Court, by supporting the IRS, strengthened this nation's commitment to nondiscrimination.

5. *Norris* — Sex-Based Annuity Tables Result in Unlawful Discrimination

In 1978 the United States Supreme Court decided in *Los Angeles Dept. of Water & Power v. Manhart*¹ that Title VII of the Civil Rights Act of 1964 prohibits an employer from requiring female employees to make larger con-

²⁰*Bob Jones*, 103 S. Ct. at 2030. In order to determine whether given activities provide a public benefit, contemporary standards must be used. See *Walz v. Tax Commissioner of New York*, 397 U.S. 664 (1970).

²¹*Bob Jones*, 103 S. Ct. at 2031.

²²*Id.* (citing *Commissioner v. Portland Cement Co.*, 450 U.S. 156, 169 (1981); *U.S. v. Correll*, 389 U.S. 299, 306-307 (1967); *Boske v. Comingore*, 177 U.S. 459, 469-470 (1900)).

²³*Bob Jones*, 103 S. Ct. at 2032.

²⁴*Id.*

¹435 U.S. 702 (1978).

tributions to a retirement system in order to obtain the same monthly pension benefits as male employees. As a follow-up to *Manhart*, the Supreme Court in *Arizona Governing Committee v. Norris*² has ruled that Title VII is also violated when an employer offers its employees the option of receiving retirement benefits from one of several companies selected by the employer, all of which pay women lower monthly retirement benefits than men who have made the same contributions as a result of the use of sex-based actuarial tables.³

The Supreme Court reasoned that Title VII requires employers to treat employees as individuals and not as members of a racial, religious, sexual, or national class.⁴ Just as it would be unlawful to use race-based actuarial tables, so too is it unlawful for the employer to rely upon sex-based tables.⁵ The traditional use of the sexual distinction to identify life expectancy differences, so as to justify class-based treatment, is no longer permitted, even though the generalization that women as a class live longer than men is true.⁶ After all, the majority opinion reasons, actuarial studies could unquestionably identify differences in life expectancy based on race or national origin, as well as sex.⁷

Having found that the Arizona deferred compensation plan violated Title VII, the Supreme Court deemed retroactive relief inappropriate, so that similar plans need only be concerned about eliminating payment differentials based on sex prospectively.⁸ Of course, any similar defined contribution plan employer can avoid even prospective adjustments by simply discontinuing the use of a life annuity as a form of benefit distribution. Indeed, this is apparently the course of action taken by the State of Arizona as a result of the *Norris* litigation.⁹ Unfortunately, eliminating the life annuity as a retirement choice may have adverse financial and tax consequences for employees.¹⁰

It should be stressed that the decision in *Norris* does not prevent insurance companies from offering sex-based annuities to the general public. The prohibition against the use of sex-based actuarial tables extends only to *employee* benefits,¹¹ and does not mean that sex-based annuities themselves are illegal.

¹103 S. Ct. 3492 (1983).

²In *Norris*, each employee had the options of selecting a lump sum payment or periodic payments for a fixed period rather than a monthly-paid annuity. These options, as well as the fact that participation in the deferred compensation plan is voluntary, were deemed irrelevant. 103 S. Ct. at 3497. n.10.

³*Id.* at 3496.

⁴*Id.* at 3498.

⁵*Id.* at 3499.

⁶*Id.* at 3498.

⁷The separate opinion written by Justice Powell cites Department of Labor Cost Study 32 as setting the cost of retroactive relief from \$817 to \$1260 million annually for the next 15 to 30 years. *Id.* at 3510.

⁸*Id.* at 3506, n.6.

⁹Alternate use of the lump sum distribution form of benefit payment may produce an extraordinary tax liability in the year of distribution, since ten-year income averaging under I.R.C. Section 402(e) does not apply to all lump sum distributions and income averaging under I.R.C. Section 1301 may not provide equivalent tax relief. Installment payments over a fixed period obviously fail to provide lifetime income security in the manner of a life annuity.

¹¹Title VII of the Civil Rights Act of 1964, 42 U.S.C. Section 2000e et seq. covers unlawful *employment* practices.

II. DEDUCTIONS

6. *Deductible Meal Expenses*

In 1983 the Treasury Department issued additional regulations relating to the computation and substantiation of meal expenses incurred in connection with travel.¹ As explained in Rev. Proc. 83-71,² the new regulations permit the taxpayer to use an optional method of computing meal expenses. Such a method reduces the taxpayer's burden of accurate record keeping.

Pursuant to section 274(d) of the Internal Revenue Code and the corresponding regulations,³ deductions for travel expenses are generally disallowed unless the business purpose, time, place and amount of each expenditure are substantiated by sufficient evidence. Prior to the 1983 amendment to the regulations under Section 274(d), the only method available for substantiating such deductions was by presenting actual receipts and other forms of primary records.⁴

Meal expenses that qualify as Section 162(a)(2) expenses paid or incurred after December 31, 1982, may be calculated on the basis of a specified per day amount.⁵ If the taxpayer elects to use this optional method, the method must be used for all meal expenses incurred during the year.⁶

The allowable meal expense deduction, under the optional method, is computed as follows:

- (a) \$14 per day for travel that requires a stay of less than 30 days in one general locality where the taxpayer's trade or business activity is conducted; or
- (b) \$9 per day for travel that requires a stay of 30 days or more in one general locality where the taxpayer's trade or business activity is conducted.⁷

The first and last day of travel away from home must be apportioned according to the actual time spent in business travel. The allowable deduction for meal expenses is prorated over each six-hour quarter of the day involved in business travel.

The optional method defined in Treas. Reg. § 1.274-5(h) applies only to meal expenses incurred in travel away from home. Respecting other such expenses, the elements of time, place, and business purpose must be substantiated

¹Treas. Reg. § 1.274-5(h) (1983), T.D. 7909, 1983-2 C.B. 55.

²Rev. Proc. 83-71, 1983-2 C.B. 590.

³Treas. Reg. §§ 1.274-1, 1.274-5 (1983).

⁴Treas. Reg. § 1.274-5(c)(2) (1982).

⁵Rev. Proc. 83-71, 1983-2 C.B. 590, 591 § 3.

⁶*Id.*

⁷*Id.* at ¶ .01.

according to the rules set forth in Treas. Reg. §§ 1.274-5(b)(2) and 1.274-5(c).⁸

Where the taxpayer is reimbursed for meal expenses, the optional method may be used only if:

- (a) the taxpayer does not receive a per diem allowance for both meals and lodging;
- (b) the reimbursement received is reflected as income on the taxpayer's federal income tax return;
- (c) the taxpayer is not required to account for the actual expenses subject to reimbursement; and
- (d) the taxpayer is not related to the person providing reimbursement, as defined in Section 267(b) of the Code.⁹

Although the new optional computation rules for meal expenses reduce the amount of record keeping for the taxpayer, it is necessary to realize that in some circumstances, the per day allowance granted under the optional method may be substantially less than the actual costs incurred for reasonable and nonextravagant meals.

7. Home Office Expense

During 1983, three taxpayers were unsuccessful in obtaining deductions for their home offices. Their attempts, however, help clarify the relationship between two subparts of Code Section 280A. Section 280A(a) provides that no deduction shall be allowed in connection with any dwelling used by the taxpayer as a residence during the taxable year.¹ Yet, Section 280A(c) provides that under certain situations a limited deduction may be taken respecting the exclusive and regular use by a taxpayer of a home office for the principal place of any trade or business, or as a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business.² The section further provided an additional requirement that any use by an employee must be for the convenience of the employer.

In *Moller v. United States*,³ taxpayers were denied a deduction for a home office because they were not engaged in a trade or business as required by Section 280A. Mr. and Mrs. Moller spend approximately 42 hours per week managing investment portfolios with a value of \$13,500,000 to \$14,500,000.⁴ Although they were involved in a variety of activities, the evidence presented indicated that the investments were purchased not for speculative purposes,

⁸*Id.* at ¶ .02.

⁹*Id.* at ¶ .05.

¹I.R.C. § 280A(a) (1982).

²I.R.C. § 280A(c)(1)(B) (1982).

³721 F.2d 810 (Fed. Cir. 1983).

⁴*Id.* at 811.

but for long-term growth potential and generation of interest and dividends.⁵

Expenses incurred in the production of income are deductible under Section 212.⁶ Since the enactment of Section 280A in 1976, however, the deduction for an office in the home is limited to activities considered a “trade or business.” The Court of Appeals for the Federal Circuit indicated that, for taxpayers to qualify as being involved in a trade or business, their investments have to be directed towards short-term trading.⁷ According to the Ninth Circuit in *Levin v. United States*,⁸ a “trader” is one who buys and sells securities with reasonable frequency so as to catch swings in the daily market movements and profit from these transactions on a short-term basis.⁹

The Court also noted that merely managing investments to maximize long-term gain is not a trade or business. This is true irrespective of the magnitude and the continuity of the portfolios being managed or of the amount of time involved in their management.¹⁰

In *Green v. Commissioner*,¹¹ the Ninth Circuit Court of Appeals considered a taxpayer who was an account executive and was responsible for the management of seven condominiums. The employer provided the taxpayer with adequate office space, but the taxpayer also maintained an office in his home. The taxpayer, although rarely meeting with clients in his home office, used the office primarily to store files and to receive incoming telephone calls from clients.¹²

The Commissioner disallowed the Section 280A(c)(1) deduction for the taxpayer’s home office. The Commissioner contended that the lack of “in-person” contact with clients in the taxpayer’s home office resulted in the disallowance of the deduction.¹³ But the Tax Court,¹⁴ in an 8-to-7 decision, ruled in favor of the taxpayers and allowed the home office deduction. The Commissioner appealed.

The Court of Appeals relied on the requirements of the plain language of the statute.¹⁵ The Commissioner and the Court agreed that the taxpayer used the room regularly and exclusively for business and that the use of the room

⁵*Id.* at 812.

⁶I.R.C. § 212 (1982).

⁷*Moller*, 721 F.2d at 815.

⁸597 F.2d 760 (Ct. Cl. 1979).

⁹*Id.* at 765.

¹⁰*Moller*, 721 F.2d at 814, (citing *Higgins v. Commissioner*, 312 U.S. 212 (1941)).

¹¹707 F.2d 404 (9th Cir. 1983).

¹²*Id.* at 405.

¹³*Green v. Commissioner*, 78 T.C. 428, 433 (1982).

¹⁴*Green*, 78 T.C. 428 (1982).

¹⁵*Green*, 707 F.2d at 406.

to receive telephone calls was for the convenience of the employer.¹⁶ The issue in dispute was whether the *clients* actually used the home office for meeting or dealing with the taxpayer, as required by Section 280A(c)(1)(a)(B).

Since the taxpayer dealt with clients only by telephone rather than in person, the Court held that the lack of actual "in person" contact in the home office resulted in the disallowance of the Section 280A(c)(1) deduction.¹⁷ The Court referred to the substantial expense a taxpayer incurs when converting a portion of a family dwelling into a home office and viewed such major expense as a sufficient reason for permitting the taxpayer to deduct home office expenses. However, the Court did not deem the conversion of a bedroom into a telephone room consistent with conversions requiring substantial expense.¹⁸

The Ninth Circuit Court of Appeals, in reversing the Tax Court decision, disallowed the I.R.C. § 280A(1)(a) deduction. In doing so, the Court has placed a more restrictive interpretation on the "use" requirement of I.R.C. § 280A(c)(1)(a)(B).

In *Frankel v. Commissioner*,¹⁹ the Tax Court disallowed a home office deduction for a newspaper editor because the office was not used by him to meet or deal with clients.

Mr. Frankel was an editor of the editorial pages of *The New York Times*. His working day started at his home in the Bronx, where he spent approximately one hour each morning reading the newspaper, clipping materials, writing memos on topics for follow-up editorials, and other activities. He then drove to the *Times*' mid-town office and remained there until approximately 7 p.m. Next, he either returned to his home or attended various business-related functions. At home, he would work in his home office in the evenings and on weekends. During the evenings, he was in constant contact with employees of the *Times* concerning changes for the second edition of the paper. He also used the evenings for telephone calls with politicians at various levels of government, labor leaders, and other community leaders.

The office at home was furnished with a desk, chairs, typewriter, filing cabinets, bookcase, telephone, dictating machine, and a small black-and-white television set used for watching public-affairs interviews, political speeches, and press conferences. He also kept basic reference books in the office which he used for writing and planning editorials.

The Court agreed that the taxpayer used the home office exclusively and on a regular basis as a place of business in the normal course of his trade or business and that the exclusive use was for the convenience of his employer,

¹⁶*Id.*

¹⁷*Id.* at 407.

¹⁸*Id.*

¹⁹82 T.C. 318 (1984).

The New York Times. However, the Court held that a home office deduction should be denied since the clients or customers did not *physically* visit the home office.²⁰

It should be stressed that the *Green* and *Frankel* cases deal with employees using an office at home. Presumably, similar deductions claimed by self-employed individuals and employees of one-person closely-held businesses who operate solely from an office in the home can be supported under the “principal place of business” language of Section 280A(c)(1)(A).

8. *Business Lunches*

Section 262 of the Internal Revenue Code disallows deductions for personal, living, and family expenses. In *Moss v. Commissioner*,¹ the United States Tax Court applied this statute so as to make nondeductible certain “business” lunches.

In *Moss* the taxpayer was a partner of a Chicago area law firm. Each day the members of the law firm would meet at the same restaurant to discuss office matters. The taxpayer asserted that it was the unwritten policy of the law firm to have all members of the firm meet for lunch to discuss the progress of various cases and other pertinent matters.²

The law firm paid for the meals during these “luncheon conferences.” On the law firm’s partnership returns for the tax years 1976 and 1977, the amount paid for such meals was included in the amount deducted for “meeting and conference” expense.³

The taxpayer was denied his proportionate share for these deductions on his individual tax return. The Commissioner disallowed such expenses and asserted that they were nondeductible personal expenses rather than ordinary and necessary business expenses.⁴ The Commissioner based his argument on the theory that although the conferences held by the law firm related to the business function of the firm, the expenditures for meals at such conferences were not ordinary and necessary.⁵

The Tax Court agreed with the position taken by the Commissioner. The Court, realizing that the dividing line between personal expenses and business expenses is not always clear, restated the test for business deductions in such situations. Following the traditional view set out in prior decisions, the Court placed the burden of proof on the taxpayer to demonstrate that the expenses

²⁰*Id.*

¹80 T.C. 1073 (1983).

²*Id.* at 1074.

³*Id.* at 1075.

⁴*Id.* at 1076.

⁵*Id.* at 1077.

claimed were in excess of the amount that would otherwise have been incurred for the taxpayer's personal purposes.⁶ Having failed to meet this burden of proof, the taxpayer was denied the deduction.

Since daily meals are an inherently personal expense, the taxpayer must prove that such expenses were directly related to an ordinary business function. Although the luncheon meetings contributed to the growth and success of the partnership, the Court held that the meal expenses alone had no *direct* relationship to such success and therefore was not deductible.

9. Determination of "At Risk" Amounts in Convertible Recourse Notes

Prior to Revenue Ruling 82-225¹ it was unclear what portion of a convertible recourse note would be deemed "at risk" for purposes of certain loss deductions.² The "at risk" limitation rules³ apply to all taxpayers engaged in certain activities.⁴ The rules limit any losses⁵ to the amount the investor could actually lose on the investment and are specifically aimed at the tax shelter investor.

The amount of the investment considered to be "at risk" is the sum of all money plus the adjusted basis of all other property contributed by the investor to the activity.⁶ Borrowed amounts are also deemed to be "at risk" if the taxpayer is personally liable for repayment of the borrowed amount, or has pledged property, other than property used in the activity, as security for the borrowed amount.⁷ However, the "at risk" amount for pledged property cannot exceed the net fair market value of the taxpayer's interest in the property.⁸ Amounts protected by non-recourse financing, guarantees, stop loss agreements, or similar arrangements are not considered to be "at risk".⁹

Although it is clear that non-recourse obligations are not amounts "at risk", a more difficult question arises when the obligation is recourse convertible to non-recourse upon the happening of one or more conditions. In these situations the amount "at risk" is determined by examining the event that causes the obligation to become non-recourse.¹⁰ For the amount to be con-

⁶*Id.* at 1076.

¹Rev. Rul. 82-225, 1982-2 C.B. 100.

²I.R.C. § 465(d) (1982).

³I.R.C. § 465 (1982).

⁴I.R.C. § 465(c) (1982). Activities affected by the "at risk" limitation rules include motion picture films or video tapes, farming, equipment leasing, oil and gas explorations or exploitations, geothermal deposit explorations or exploitations, and other activities in which a taxpayer is engaged for carrying on a trade or business, or for the production of income, not including real estate.

⁵I.R.C. § 465(b) (1982).

⁶I.R.C. § 465(b)(1) (1982).

⁷I.R.C. § 465(b)(2) (1982).

⁸*Id.*

⁹I.R.C. § 465(b)(4) (1982).

¹⁰Rev. Rul. 82-225, 1982-2 C.B. 100-101.

sidered “at risk”, the event causing the conversion must have a substantial economic relationship to the investment activity.¹¹

Satisfaction of the economic relationship test occurs when the property involved in the activity eventually has sufficient value to support the debt obligation without the need of the investor’s personal liability protection.¹² For example, if the activity property is an orchard, the economic relationship test will be satisfied when the orchard has reached a certain stage of development so that its value is sufficient to support the debt obligation.¹³ Likewise, when a movie reaches a certain stage of completion or generates a certain level of box office receipts, satisfaction of the economic relationship test will result.¹⁴ However, if the event causing the conversion from recourse to non-recourse has no substantial economic relationship but only exists to increase the “at risk” amount, the partial recourse note will be treated as non-recourse and considered “at risk”.¹⁵ Therefore, no loss deduction can be claimed against that amount.

10. Charitable Contributions or Tuition?

In Revenue Ruling 83-104¹ the Internal Revenue Service sets forth six factual situations to illustrate the distinction between qualified charitable contributions and tuition payments made to an organization that operates a private school. In each of the factual situations the donee is an organization described in Section 170(c) of the Internal Revenue Code. The taxpayer in each situation is the parent of a child who attends the school. The parent makes a payment to the organization and such payment is not more than the cost of educating the child.

The issue involved in these situations is whether a parent’s contribution to an organization can qualify for the charitable contribution deduction. Under Section 170 of the Code,² an individual can claim a deduction for contributions or gifts made to certain qualifying organizations.³ A contribution cannot be deducted, however, unless it was voluntarily made without the expectation of receiving any financial benefit in exchange.⁴ Therefore, tuition payments would not be deductible because the parent receives a benefit⁵ in exchange for his contribution.

¹Rev. Rul. 81-283, 1981-2 C.B. 115.

²*Id.*

³S. REP. NO. 938, 94th Cong., 2nd Sess. 48 n.l, reprinted in 1976-3 C.B. 57, 86 n.l.

⁴H.R. REP. NO. 658, 94th Cong., 1st Sess. 110 n. 10, reprinted in 1976-3 C.B. 701, 802 n. 10.

⁵Rev. Rul. 82-225, 1982-2 C.B. 100-101.

¹Rev. Rul. 83-104, 1983-2 C.B. 46 (superseding Rev. Rul. 79-99).

²I.R.C. § 170(a) (1982).

³I.R.C. § 170(c) (1982).

⁴However, procuring a financial benefit relating to one’s trade or business may result in a deduction under Section 162 see Treas. Reg. § 1.170 A-1(c)(5) (1972).

⁵The benefit received is having the child educated. Rev. Rul. 83-104, 1983-2 C.B. 46-47.

In determining whether a contribution was made voluntarily without any expectation of obtaining a benefit in exchange, the Service sets forth the following list of factors to be considered: the existence of a contract under which a taxpayer agrees to make a "contribution" and which contains provisions ensuring the admission of the taxpayer's child; a plan allowing the taxpayers either to pay tuition or to make "contributions" in exchange for schooling; the earmarking of a contribution for the direct benefit of a particular individual; or the otherwise unexplained denial of admission or readmission to a school of children of taxpayers who are financially able, but who do not contribute.⁶ The presence of any one of the above-mentioned factors may result in the denial of Section 170 deductions.

In a recent case before the Tax Court,⁷ the presence of some of these factors proved to be fatal to a parent claiming a charitable deduction for payments made to a parochial school. The parent had made payments totalling \$900 in the form of checks. Some of these checks bore the notations "for Lora's account", "for Lora's tuition" or "for Bob and Lora's tuition." Since these payments were earmarked for tuition of specific individuals, the charitable deduction was accordingly denied.

The Service also states that although no single factor may be determinative, a combination of several additional factors may indicate that a payment is not a charitable contribution. Such factors include: (1) the absence of a significant tuition charge; (2) substantial or unusual pressure to contribute applied to parents of children attending a school; (3) contribution appeals made as part of the admissions or enrollment process; (4) the absence of significant potential sources of revenue for operating the school other than contributions by parents of children attending the school; and (5) other indicia suggesting that a contribution policy has been created as a means of avoiding the characterization of payments as tuition.⁸

Ordinarily the presence of any one of these other factors will not result in denial of the Section 170 deduction. However, the existence of a combination of these other factors may result in denial of the deduction. Thus, in a situation where no tuition is charged, where solicitation materials are part of the school's application materials, and where parents of applicants are singled out as a class for solicitation, no charitable deduction will be allowed.⁹

11. *Deductions Relating to Temporary Rental of a Residence*

Homeowners who undergo job transfers or who otherwise change residences often rent or attempt to rent their old residence pending its sale.

⁶*Id.*

⁷Howard Lee Bass, 52 TAX CT. MEM. DEC. (P-H) ¶ 83,536 (1983).

⁸Rev. Rul. 83-104, 1983-2 C.B. 46.

⁹*Id.* (This describes situation #2 of the Revenue Ruling).

Such was the case with the married taxpayers in *Bolaris v. Commissioner*,¹ who attempted to deduct rental activity amounts in excess of rental income for two taxable years,² while deferring a realized gain on the eventual sale of the old residence under Section 1034.³

The Tax Court viewed the taxpayers' deductions beyond rental income as subject to disallowance under Section 183(b),⁴ which allows deductions normally connected with activities engaged in for profit⁵ only to the extent that income from an "activity not engaged in for profit" exceeds related deductions, such as those for interest and property taxes,⁶ that are allowable irrespective of one's profit motives. The Court found the rental activity in question, which resulted in the taxpayers' receiving fair market value rental payments for a period of about nine months, to be merely "ancillary to sales efforts," and that the taxpayers' "primary motive in leasing the property was to sell it at the earliest possible moment rather than to hold it for the production of income."⁷ Thus, the Court deemed the taxpayers' rental activity correspondingly not to interfere with a characterization of their old residence as a "principal residence" for purposes of deferring gain recognition under Section 1034, since the term "residence" could be consistently applied to a dwelling that was not used in a "trade or business" or "held for the production of income," as these latter terms are used in Sections 162, 167, and 212.

As Judge Wilbur pointed out in his dissent, an allowance of a tax benefit under Section 1034 could be viewed as a basis for consistently disallowing tax benefits under Sections 167 and 212 if it were clear that Congress intended Section 1034 and Sections 167 and 212 to be mutually exclusive in their application. Nevertheless, such mutual exclusivity was not intended, since Congress specifically stated that either the old or new residence could be temporarily rented (presumably with an economic or profit motivation) consistently with the application of Section 1034.⁸ This issue of legislative intent may play a role in the treatment of such deductions by other federal courts in the future. These courts may also have to consider the effect of a series of cases that allowed deductions based on the "held for the production of income" standard even when the taxpayer had been unsuccessful in attempting to rent residential

¹*Bolaris v. Commissioner* 81 T.C. 840 (1983).

²Mr. and Mrs. Bolaris had rental income of \$1271 and \$2717 for the years at issue, 1977 and 1978 respectively. Their total rental related deductions for 1977 and 1978 exceeded rental income by \$3,738 and \$4,727 respectively. *Id.* at 843.

³I.R.C. § 1034 (1982).

⁴I.R.C. § 183(b) (1982).

⁵These deductions include those for depreciation, maintenance, insurance, and similar expenses otherwise allowed by I.R.C. Sections 162, 167, and 212 respecting real estate rental activity.

⁶I.R.C. §§ 163, 164 (1982).

⁷*Bolaris*, 81 T.C. at 847.

⁸Judge Wilbur cites H.R. REP. NO. 586, 82d Cong., 1st Sess., p. 109 (1951), 1951-2 C.B. 357, 377; S. REP. NO. 781 82d Cong., 1st Sess., p. 32 (1951), 1951-2 C.B. 458, 483.

property.⁹

If one reads the *Bolaris* decision in light of its expressed reasoning, disallowance of deductions under Section 183 should be upheld by the Tax Court anytime rental activity is only ancillary to a primary attempt to sell a residence, regardless of whether the taxpayer otherwise qualifies for or attempts to use Section 1034. Since the nonprofit-motivated deductions for interest and property taxes allowed under Sections 163 and 164 typically severely limit or eliminate the use of profit-related deductions as a result of Section 183(b), a large enough number of taxpayers will be affected by *Bolaris* so as to assure ample future litigation.

Hopefully, *Bolaris* will not serve as a basis for denying capital loss deductions under similar circumstances.¹⁰ In order for a homeowner to recognize a capital loss, the loss must be "incurred in any transaction entered into for profit under Section 165(c)(2)."¹¹ Although the literal code language would suggest at first glance that sale of a residence could not qualify for loss recognition since the acquiring transaction was personal and not profit-motivated, the Treasury Regulations under Section 165¹² clearly permit a loss deduction respecting sale of property acquired as a personal residence but converted to rental use prior to sale. Indeed, the regulations contain an example that illustrates a recognized loss for a taxpayer who acquired a personal residence, lived in it for nine years, and then rented it for thirty-six months prior to selling it.¹³ No distinction is made in the regulations under Section 165 between rental conversions merely "ancillary" to an intention to sell and conversions motivated solely by profit considerations,¹⁴ although the Court that decided *Bolaris* might otherwise view the length of the rental period as determinative at some point. In the past, however, the Tax Court has been willing to recognize short rental periods as establishing an income-producing use,¹⁵ and taxpayers should hope that such tendency will continue, at least respecting Section 165 losses, notwithstanding the reasoning in *Bolaris*.

⁹*Briley v. U.S.*, 298 F.2d 161 (6th Cir. 1962); *Horrman v. Commissioner*, 17 T.C. 903 (1951); *Robinson v. Commissioner*, 2 T.C. 305 (1943).

¹⁰Taxpayers who purchase and sell their first residence in a "down" real estate market may realize losses, as well as taxpayers who purchase and sell two homes during the Section 1034 replacement period, when only the last of the subsequently purchased homes qualifies as the Section 1034 replacement residence.

¹¹I.R.C. § 165(c)(2) (1982).

¹²Treas. Regs. § 1.165-9(b) (1964).

¹³Treas. Regs. § 1.165-9(c), Ex. (1) (1964).

¹⁴One may note here that "legitimate" real estate investments are often motivated by total economic benefits, which include, of course, both tax benefits and prospects for future appreciation. In many instances, such motivations are sufficient to induce purchases even though operating expenses meet or exceed a project's cash flow, and the project is not otherwise structured as an "abusive tax shelter." Should motivations for profit based in part on tax benefits be permitted to affect tax consequence when one temporarily invests in an apartment building but be denied when one temporarily rents a residence while awaiting an adequate purchase offer rather than market appreciation?

¹⁵*Compare* *Froehl, Jr.*, 30 TAX CT. MEM. DEC. (P-H) ¶ 61,093 (Rental for 2 to 3 months insufficient to convert residence to "income-producing property") with *Rechnitzer*, 36 TAX CT. MEM. DEC. (P-H) ¶ 67,055 (Loss allowed where rental before sale was only three months at a very small profit after depreciation.).

12. *Business Expenses Nondeductible Due to Lack of Compensation*

Key shareholder/employees of closely-held businesses who draw no salary during the start-up phase of an enterprise, or while the corporation retains earnings for future use, should consider the effect of foregoing compensation on the availability of personal business expense deductions relating to the enterprise under I.R.C. Sections 162 and 212. In *Robert L. Van Fossan, Jr. v. Commissioner*,¹ the taxpayer was president and 50-percent shareholder in a corporation formed to operate a restaurant business located 126 miles from the taxpayer's residence. In order to be readily available to work in the restaurant operation, the taxpayer purchased a nearby condominium and thus incurred substantial living expenses while away from home.² He attempted unsuccessfully to support his deductions for these expenses as ordinary and necessary business or property management expenses under I.R.C. Sections 162 or 212, even though he served as an officer and director of the corporation without present or prospective compensation while working at the restaurant as much as ten to fifteen hours per day.³

The Court in *Van Fossen, Jr.* emphasized that the record in the case contained no indication that the taxpayer might obtain compensation for his efforts from the corporation in future years and that the "mere speculative possibility" of such was insufficient to support a finding that Mr. Van Fossen, Jr., was engaged in a trade or business activity sufficient to allow his deductions.⁴ Presumably, payment of more than nominal compensation by the corporation during the taxable years in question would have made a crucial difference in tax results.⁵ As a planning proposition, such payments to similarly situated shareholder/employees would be recommended, but what if the cash cannot be spared?

In such event, the ultimate paying of compensation could be established through an employment agreement providing for future payments to the shareholder/employee. Deferred, or even contingent future compensation, contractually determined, would at least give the taxpayer a fighting chance to

¹52 TAX CT. MEM. DEC. ¶ 83,703 (1983).

²The taxpayer did not submit claims for reimbursement to the corporation for such expenses.

³Thus, for purposes of Section 162, without compensation he was not engaged in the trade or business of being an employee of the corporation, and for purposes of Section 212(2), his expenses were deemed to relate directly to the business of the corporation and not directly to his position as a shareholder, or owner of potentially dividend-paying property. In writing his opinion in *Van Fossan, Jr.*, Judge Tannenwald cites, among other cases dealing with the Section 212 concept, *Deputy v. Dupont*, 308 U.S. 488 (1940), which gives the statutory term "ordinary" the meaning of a "common or frequent occurrence in the type of business involved." 308 U.S. 488 at 495. Apparently, the logic applied in *Van Fossen, Jr.* is to the effect that a shareholder normally does not manage or conserve the income-producing capacity of shares of stock by getting directly involved in the corporation's business operation. This reasoning perhaps ignores the realities of owning a substantial interest in a closely-held business entity.

⁴*Van Fossen, Jr.*, 52 TAX CT. MEM. DEC. (P-H) ¶ 83,703 at 2922.

⁵Particularly if compensation exceeding the claimed deductions had been paid so as to eliminate adjustments under I.R.C. Section 183 resulting from the potential assertion that the taxpayer's employment activity was not "engaged in for profit."

obtain otherwise appropriate deductions under Section 162.

Establishing compensation so as to establish the trade or business of being an employee appears to be the most productive approach toward allowance of personal business expense deductions, since the Tax Court seems not to be impressed by Section 212 arguments based upon the motivations of taxpayers like Van Fossen, Jr. who devote extraordinary amounts of time, energy, and resources to a new business in what must be the hope that someday the business will afford them a substantial realizable value.⁶

If the requisite compensation cannot be established so as to support business expense deductions under Section 162, perhaps the taxpayer's only other hope to obtain a tax benefit from such expenses is an application of the contribution to capital concept, which might result in an increase in the shareholder/employee's basis in his shares.⁷ If Section 212 deductions are to be denied on the ground that the taxpayer's activities are directly related to the production of income to the corporation and the management of its property rather than to production of income to the taxpayer and management of his shares, it may not be far-fetched to agree that the taxpayer's expenditures connected with such activities are tantamount to contributions to the corporation's working capital.

III. LEGISLATION AND TREASURY REGULATIONS

13. *Technical Corrections Act of 1982*

In January of 1983 the Technical Corrections Act of 1982¹ was enacted to supplement the Economic Recovery Tax Act of 1981,² the Crude Oil Windfall Profit Tax Act of 1980,³ the Bankruptcy Tax Act of 1980,⁴ and the Tax Equity and Fiscal Responsibility Act of 1982.⁵ Only a selection of these technical amendments will be discussed.

A. *Accelerated Cost Recovery System*

Realty, classified as 15-year property under the Accelerated Cost Recovery System (ACRS),⁶ for the year the property is placed in, or taken out of service, will have recovery allowances determined according to the number of months

⁶Denial of deductions under Section 212 under such circumstances no doubt results in at least an indirect disincentive toward entrepreneurial activity.

⁷"Payments" made to (and perhaps for the benefit of) a corporation represent an additional price paid for the shares of stock held by the individual shareholder who makes such payments. Treas. Reg. § 1.118-1 (1960)

¹Pub. L. No. 97-448, 96 Stat. 2365 (1982).

²Pub. L. No. 97-34, 95 Stat. 172 (1981).

³Pub. L. No. 96-223, 94 Stat. 229 (1980).

⁴Pub. L. No. 96-589, 94 Stat. 3389 (1980).

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

⁶I.R.C. § 168 (1982).

the property was in service, regardless of the length of the taxpayer's taxable year or recovery period or recovery method used by the taxpayer.⁷ The "anti-churning" rules of ACRS⁸ were amended to clarify that ACRS allowances can be applied to property received as a result of death, if the basis of the property is determined under I.R.C. Section 1014(a), even though the property was placed in service before 1981.⁹ Thus, the "anti-churning" rules apparently would deny ACRS allowances respecting property received from a decedent (and placed in service before 1981) if the property were appreciated property acquired by the decedent by gift within one year prior to the decedent's death from the person who received the property as a result of the decedent's death. This would be the result since the basis of such property would not be "stepped-up" under Section 1014(a).¹⁰

B. IRA Contributions for a Spouse

A spouse having compensation who is age 70½ or older is now clearly permitted to make an IRA contribution for the benefit of a spouse having no compensation as long as the non-earning spouse has not attained age 70½ prior to the close of the taxable year.¹¹

C. Qualified Terminable Interest Property

The Technical Corrections Act of 1982 includes a number of clarifying provisions respecting the use of qualified terminable interest property (QTIP) in obtaining an estate tax marital deduction.¹² Among these is a provision specifying that QTIP property included in the transferee spouse's estate pursuant to Section 2044 is eligible for a "step-up" in basis.¹³ This is consistent with other QTIP clarifications in the Act to the effect that an inclusion under Section 2044 in the estate of the second spouse who dies results in the QTIP property being treated as passing directly from that spouse for transfer tax purposes in general, including application of the charitable transfer deduction of I.R.C. Section 2055.¹⁴

D. Current Use Valuation under Section 2032A.

Among other technical changes, the current use valuation provisions of I.R.C. Section 2032A now permit "tacking" of material participation by a

⁷S. REP. NO. 592, 97th Cong., 2d Sess. 1, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 4149, 4153-54.

⁸I.R.C. § 168(e)(4) (1982).

⁹I.R.C. § 168(e)(4)(H) (1982).

¹⁰I.R.C. § 1014(e) gives the donor/heir the decedent's basis as determined *immediately before* his death — generally speaking a carryover basis as determined under I.R.C. Section 1015.

¹¹I.R.C. §§ 219(d) (1982); S. REP. NO. 592, 97th Cong., 2d Sess. 1, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 4149, 4153-54.

¹²See I.R.C. §§ 2056(b)(7) and 2044 (1982). Respecting the role of QTIP property in the gift tax structure, see I.R.C. Sections 2519 and 2523. Generally, a transfer of QTIP property permits the transferor a life income interest while denying control over disposition of the remainder. Prior to the Economic Recovery Tax Act of 1981 such transfers would have precluded a marital deduction for transfer tax purposes.

¹³I.R.C. § 1014(b)(10) (1982).

¹⁴S. REP. NO. 592, 97th Cong., 2d Sess. 1, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 4149, 4167-69.

retired spouse with active management by the surviving spouse to obtain the lower current use value for the surviving spouse's estate where the spouse dies fewer than eight years after the death of the first spouse.¹⁵ Thus, the number of estates that can take advantage of current use valuation has been expanded.

E. Gifts Made within 3 Years of Decedent's Death.

For decedents dying after 1981 only a limited category of transfers made within three years of death will result in an inclusion under I.R.C. Section 2035 in the gross estate of the transferor. For example, disposition by gift within three years of death of a life estate retained in a manner that would have resulted in an inclusion in the donor's gross estate had the interest been retained at death¹⁶ will nevertheless result in an inclusion under the three year rule.¹⁷ As a result of the Technical Corrections Act of 1982, the category of such transfers no longer includes exercises of general powers of appointment, so that such an exercise within three years of death will not result in an inclusion in the exerciser/decedent's gross estate.¹⁸

F. Recapture of Section 179 Deduction.

I.R.C. Section 179 allows a limited amount of property acquired for use in a trade or business to be immediately "expensed" rather than subjected to cost recovery allowances over a period of years under Section 168. Under the Act, in a taxable year in which it is determined that property so expensed is no longer used "predominantly" in a trade or business, the taxpayer must include in income, the tax benefit derived from the expensing deduction.¹⁹ The Internal Revenue Service issued instructions to the 1983 Form 1040 that explain the IRS's interpretation of this "recapture" provision. The instructions provide that the amount to be added back to income is obtained by subtracting from the Section 179 deduction previously taken the recovery allowances under Section 168 that would have been allowed on the Section 179 amount from the time the property was placed in service until the taxable year of recapture.²⁰

14. Social Security Amendments of 1983

Extensive changes were made in the social security laws by the Social Security Amendments of 1983.¹ One of the most important changes occurred

¹⁵I.R.C. § 2032A(b)(5)(c) (1982).

¹⁶See I.R.C. § 2036(a)(1) (1982).

¹⁷I.R.C. § 2035(d)(2) (1982) specifically mentions transfers that relate to I.R.C. §§ 2036, 2037, 2038, and 2042.

¹⁸Such an exercise may have gift tax consequences under I.R.C. § 2514, but the reference to I.R.C. § 2041 is now deleted from § 2035(d)(2), so that valuation of the transfer for transfer tax purposes is geared to the date of the gift rather than the date of death.

¹⁹H.R. CONF. REP. 986, 97th Cong., 2d Sess. 15, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 4203, 4215-16.

²⁰The recapture is triggered by a reduction in the business use of the subject property to 50% or less. The addition to income is reported on Form 4797.

¹Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983). Due to the extensive legislation, only the major changes will be discussed here.

with the change in the tax rates.² Effective December 31, 1983,³ both employees⁴ and employers⁵ will pay Federal Insurance Contributions Act (FICA) taxes at an accelerated rate.⁶ Although the FICA tax rates are accelerated for the years 1984 through 1989, the 1990 tax rate remains the same. At the same time, the Social Security Amendments of 1983 allow an income tax credit for employees against the tax increases in 1984.⁷

The Amendments of 1983 also increase the tax rates on self-employment income⁸ in order to correct the disparity between self-employment rates and the combined employee-employer rates.⁹ The Social Security Amendments of 1983 also increase the hospital insurance rates for self-employment income.¹⁰

Prior to the Social Security Amendments of 1983, social security benefits¹¹ were not included in the taxpayer's gross income for income tax purposes. But under the new legislation, these benefits are included in the taxpayer's gross income up to the lesser of one-half of the benefits received, or one-half the excess of the sum of the taxpayer's adjusted gross income¹² plus one-half of the social security benefits received over the base amount.¹³ By doing this, Congress is able to tap a source of income tax that had not previously been tapped.

²Social Security Amendments of 1983, Pub. L. No. 98-21, § 123, 97 Stat. 65, 87-88 (1983) (codified as amended at I.R.C. §§ 3101(a), 3111(a)).

³*Id.* at § 123(a)(3).

⁴*Id.* at § 123(a)(1).

⁵*Id.* at § 123(a)(2).

⁶Under prior law, the employee's portion of the old-age, survivors, and disability insurance (OASDI) tax was to be 5.4% for 1984, 5.70% for the years 1985 through 1989, and 6.20% for the years after 1989. Under the new law, the employee's portion of the same tax will be 5.70% for the years 1984 through 1987, 6.06% for the years 1988 and 1989, and 6.20% for 1990 and after. The employer's portion of the OASDI tax is identical to the employee's portion, both before and after the 1983 legislation.

⁷Social Security Amendments of 1983, Pub. L. No. 98-21, § 123(b), 97 Stat. 65, 88 (1983) (codified as amended at I.R.C. § 3510).

⁸Social Security Amendments of 1983, Pub. L. No. 98-21 § 124, 97 Stat. 65, 89 (1983) (codified as amended at I.R.C. § 1401(a), (b)).

⁹Under the prior law, the OASDI tax rate on self-employment income was 8.05% for 1981 through 1984, 8.55% for 1985 through 1989 and 9.30% for 1990 and after. After the Amendments of 1983, the OASDI rates for self-employment income are 11.40% for January 1, 1984, through December 31, 1987, 12.12% for January 1, 1988, through December 31, 1989, and 12.40% after December 31, 1989.

¹⁰Under the prior law, the hospital insurance rate on self-employment income was 1.3% for January 1, 1981, through December 31, 1984, 1.35% for January 1, 1985, through December 31, 1985, and 1.45% for January 1, 1986 and after. The Amendments of 1983 increased the hospital insurance rates for self-employment income to 2.70% for tax years beginning in 1984, 2.3% for the year 1985, and 2.0% for the years 1986 through 1989.

¹¹Here, social security benefits include any amount received under monthly benefits of OASDI or benefits under Tier I of the Railroad Retirement Act of 1974.

¹²This adjusted gross income is modified by I.R.C. § 86(d) (1982), by adding back any deduction taken by a married couple for two-earner income, or any earned foreign income exclusion. Also, the taxpayer must add all tax-exempt interest, such as the interest on municipal bonds.

¹³Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 65, 80 (1983). The base amount under this law is \$32,000 for a married person filing a joint return; zero for a married person not filing a joint return; and \$25,000 for a single person, or a married person living apart from his or her spouse for the entire year or filing separately.

The Social Security Amendments of 1983 changed some of the benefits under the social security system. The Amendments of 1983 shift the cost-of-living increases from the middle of the year, as they had been in the past, to the end of the year.¹⁴ By pushing back this cost-of-living increase for six months, it in effect provides a permanent reduction in benefits to beneficiaries and a permanent savings to the social security system.

Before the 1983 Amendments, a qualified retiree normally collected his or her full benefits at age 65. Under the 1983 changes, this age will gradually be increased so that by the year 2022, the age at which a retiree can collect his or her full benefits will be 67.¹⁵ This recent change does not affect the early retirement age with reduced benefits, which remains at 62. Additionally, before 1983, a beneficiary or dependent under age 70 had part of his or her benefits reduced if the beneficiary was working and earning over a specific amount. Under the new law, a divorced spouse's benefits will not be reduced because of the insured's excess earnings.¹⁶

Under prior law, a person who was eligible for a public or government pension had to offset the benefits received on a dollar-for-dollar basis with social security benefits. Effective as of July 1, 1983, public pensions must only be offset up to two-thirds of their total.¹⁷

The Social Security Amendments of 1983 provide for a liberalization of the retirement test beginning in 1990.¹⁸ Before the 1983 Amendments, persons 65 or older were required to offset one dollar of benefits for every two dollars earned over the annual exempt amount.¹⁹ The 1983 legislation changed this offset and now a person must offset one dollar of benefits for every three dollars earned over the annual exempt amount.²⁰

A worker who delays retirement benefits beyond age 65 is entitled to an increase in the old-age benefits. This is provided as an incentive to delay retirement before age 65 and thereby delay benefit payments by the Social Security Administration. In the past this increase was 3% for each year in which the worker between ages 65 and 72 does not receive any benefits. After 1983, a delayed retirement credit will be gradually phased in to increase the percent-

¹⁴Social Security Amendments of 1983, Pub. L. No. 98-21, § 111, 97 Stat. 65, 72-73 (1983) (codified as amended at Social Security Act § 215(i)(2)(A)(ii)).

¹⁵Social Security Amendments of 1983, Pub. L. No. 98-21, § 201, 97 Stat. 65, 107-109 (1983) (codified as amended at Social Security Act § 216(a)).

¹⁶Social Security Amendments of 1983, Publ. L. No. 98-21, § 132, 97 Stat. 65, 93-95 (1983) (codified as amended at Social Security Act §§ 203(b)(2), (d)(1)(B), (f)(7)).

¹⁷Social Security Amendments of 1983, Pub. L. No. 98-21, § 337, 97 Stat. 65, 131-32 (1983) (codified as amended at Social Security Act §§ 202(b)(4)(A), (c)(2)(A), (f)(2)(A), (g)(4)(A) and § 202(e)(7)(A)).

¹⁸Social Security Amendments of 1983, Pub. L. No. 98-21, § 347, 97 Stat. 65, 138 (1983) (codified as amended at Social Security Act § 203(f)(3)).

¹⁹Social Security Act § 203(f)(3) (1982).

²⁰Social Security Act § 203(f)(3) (1983).

age to 3½ % by 1990.²¹ Additionally, the maximum increase permitted will be extended in 2008.²²

The Social Security Amendments of 1983 also changes the scope of Social Security coverage. Prior to 1984, federal employees were excluded from coverage under the social security system. Under the 1983 Amendments, all federal employees hired on or after January 1, 1984, will be brought into the social security system.²³ In addition, the system will now include all legislative branch employees not participating in the Civil Service Retirement System,²⁴ all members of Congress,²⁵ the President,²⁶ Vice President,²⁷ all federal judges,²⁸ and all executive and senior executive political appointees.²⁹ Another group which had previously been excluded from coverage under the Social Security system and which will be covered as of 1984, is employees of nonprofit organizations.³⁰

Contributions by an employer to a qualified cash or deferred compensation plan defined in I.R.C. § 401(k) are also includible in the Social Security wage base³¹ beginning in 1984. Includibility is limited to the extent that the employee could have elected to receive cash in place of the contribution.³² The employer's contributions to such a plan are taxable regardless of whether the cash or deferred arrangement is part of a cafeteria plan.³³ Employer contributions to tax-sheltered annuities are also includible in the wage base, if made due to a salary reduction agreement.³⁴

²¹Social Security Amendments of 1983, Pub. L. No. 98-21, § 114, 97 Stat. 65, 79 (1983) (codified as amended at Social Security Act § 202(w)).

²²*Id.*

²³Social Security Amendments of 1983, Pub. L. No. 98-21 § 101, 97 Stat. 65, 67-70 (1983) (codified as amended at Social Security Act § 210 (a)).

²⁴Social Security Amendments of 1983, Pub. L. No. 98-21 § 101(a)(1), 97 Stat. 65, 68 (1983) (codified as amended at Social Security Act § 210(a)(6)(v)).

²⁵Social Security Amendments of 1983, Pub. L. No. 98-21 § 101(a)(1), 97 Stat. 65, 68 (1983) (codified as amended at Social Security Act § 210(a)(6)(iv)).

²⁶Social Security Amendments of 1983, Pub. L. No. 98-21, § 101(a)(1), 97 Stat. 65, 68 (1983) (codified as amended at Social Security Act § 210(a)(6)(i)).

²⁷*Id.*

²⁸Social Security Amendments of 1983, Pub. L. No. 98-21, § 101(a)(1), 97 Stat. 65, 68 (1983) (codified as amended at Social Security Act § 210(a)(6)(iii)).

²⁹Social Security Amendments of 1983, Pub. L. No. 98-21, § 101(a)(1), 97 Stat. 65, 68 (1983) (codified as amended at Social Security Act §§ 210(a)(6)(ii) & (iii)).

³⁰Social Security Amendments of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71 (1983) (codified as amended at Social Security Act § 210(a)(8)).

³¹The social security wage base is the maximum amount of wages that the social security system uses to determine FICA taxes.

³²Social Security Amendments of 1983, Pub. L. No. 98-21, § 324, 97 Stat. 65, 122-126 (1983). *See also* H.R. CONF. REP. NO. 47, 98th Cong., 1st Sess. 146, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 404, 436.

³³H.R. CONF. REP. NO. 47, 98th Cong., 1st Sess. 147, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 404, 437. Cafeteria plans are fringe benefit plans which allow an employee to select certain fringe benefits up to a certain dollar amount, in addition to a basic fringe benefit plan.

³⁴Social Security Amendments of 1983, Pub. L. No. 98-21, § 324, 97 Stat. 65, 122-126 (1983).

15. *Multiple Trusts Regulations*

Treasury Regulation Section 1.641(a)–0(c) provides that multiple trusts will be consolidated and treated as one trust for the purposes of subchapter J, if the trusts have no substantially independent purposes,¹ have the same grantor and substantially the same beneficiary,² and if the avoidance or mitigation of taxes was the principal purpose.³ However, in a recent Tax Court decision, *Edward L. Stephenson Trust v. Commissioner*,⁴ the Tax Court held this regulation invalid.

Stephenson involved two cases, both concerning the consolidation of two trusts by the Commissioner of the Internal Revenue Service (IRS). In this case the simple trust⁵ held shares of high grade equities and all the income was distributed currently. The second trust was an accumulation trust⁶ that held distributions received from the simple trust as well as accumulations of its own. During the years in question, the simple trust distributed most of its income to the accumulation trust and each trust filed a separate return. Using Treasury Regulation Section 1.641(a)–0(c), the Internal Revenue Service consolidated both of the trusts into one, thereby increasing the total tax.

In *Stephenson*, the Tax Court gave judgment for the taxpayers, holding Treasury Regulation Section 1.641(a)–0(c) invalid. In keeping with their decision in *Estelle Morris Trust v. Commissioner*,⁷ the court found that multiple trusts were separate taxable entities regardless of a tax avoidance purpose. In the *Estelle Morris Trust* decision, the Tax Court had rejected the consolidation of trusts approach advanced by the Internal Revenue Service and allowed multiple trust to be taxed separately.

In the Tax Reform act of 1969,⁸ Congress eliminated some of the tax benefits associated with multiple trusts⁹ without altering the status of multiple trusts as separate taxable entities by eliminating the five-year limitation and all exceptions to the throwback rule.¹⁰ In 1972, the consolidation regulation¹¹

¹Treas. Reg. § 1.641(a)–0(c)(1), T.D. 7204, 1972-2 C.B. 352, 393 (1972).

²Treas. Reg. § 1.641(a)–0(c)(2), T.D. 7204, 1972-2 C.B. 352, 393 (1972).

³Treas. Reg. § 1.641(a)–0(c)(2), T.D. 7204, 1972-2 C.B. 352, 393-394 (1972).

⁴81 T.C. 283 (1983).

⁵I.R.C. § 651 (1982) explains what qualifies as a simple trust. Basically, simple trusts are trusts whose income is currently distributed.

⁶I.R.C. § 661 (1982) explains what qualifies as an accumulation trust. Basically, accumulation trusts are trusts whose current income is accumulated and added to the corpus instead of being currently distributed.

⁷51 T.C. 20 (1968), *aff'd per curiam*, 427 F.2d 1361 (9th Cir. 1970).

⁸Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

⁹Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 331, 665-669, 83 Stat. 487, 592-599 (1969).

¹⁰Treas. Reg. § 1.665(a)–0A(a)(3), T.D. 7204, 1972-2 C.B. 352, 355 (1972). Under the throwback rule, an accumulation trust's eventual distribution of accumulated income will be taxed to the beneficiary as if it had been currently distributed to the beneficiary.

¹¹Treas. Reg. § 1.641(a)–0(c), T.D. 7204, 1972-2 C.B. 352, 393-394 (1972).

was promulgated as part of the regulations interpreting the 1969 Act.¹²

The Commissioner used the reenactment doctrine by arguing¹³ in *Stephenson* that Congress approved the consolidation regulation, since it did not overrule the regulation in its consideration of multiple trusts under the Tax Reform Act of 1976.¹⁴ The Tax Court held that the reenactment doctrine did not apply to the consolidation regulation because the 1976 Act added the so-called “Third Trust Rule” with I.R.C. Section 667(c), which provided a method for eliminating abuses of multiple trusts inconsistent with consolidating multiple trusts under the regulation. Thus the Court held that the consolidation regulation, Treasury Regulation Section 1.641(a)–0(c) of the income tax regulations, added restrictions not contemplated by Congress and was therefore invalid.

Because of the progressive tax rates under which trusts are taxed, if trust income is split between two or more trusts instead of one, the tax from each would be less than if all were consolidated and taxed as one. For example, assume that a trust has annual taxable trust income of \$35,000 which is not distributed currently.¹⁵ If this income was taxed in one trust, the resulting tax would be \$11,398.¹⁶ But if this same taxable trust income was divided between two trusts, the tax bill would be \$3137 for each, for a total of \$7330.¹⁷ This disparity is of course due to the use of progressive tax tables and obviously serves as a tax planning device.

The I.R.S. has not acquiesced to *Stephenson*. Therefore it is likely that even though the Tax Court states that multiple trusts are separate entities for tax purposes, the I.R.S. will continue to contest most multiple trust arrangements. Additionally, recently proposed legislation¹⁸ seems to accept the I.R.S. position. Therefore it is likely that in the future, multiple trusts that have the same grantor and beneficiary, no substantially independent purpose, and tax avoidance as a principal purpose, will be consolidated and taxed as one entity. Thus, the future use of multiple trusts as a tax planning device may be of limited utility.

¹²T.D. 7204, 1972-2 C.B. 352 (1972).

¹³*Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

¹⁴Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

¹⁵This is an example of an accumulation trust in which income is accumulated and not distributed when earned.

¹⁶This is a simplified example used to illustrate the possible tax advantages of multiple trusts, not taking into consideration credits or deductions against the tax under I.R.C. § 642.

¹⁷Trust income of \$35,000 would be taxed at a 42% marginal tax rate while trust income of \$17,500 for two trusts would be taxed at a 33% marginal tax rate.

¹⁸The proposed legislation is out of the Committee on Ways and Means and the Senate Finance Committee and at the time of this printing is under consideration by the Conference Committee. The House version of the bill is referred to as the Tax Reform Act of 1984, while the Senate version is called the Deficit Reduction Tax Bill of 1984. Both contain legislation in each Act respectively at Section 82 to codify Treas. Reg. § 1.641(a)–0(c)(1) (1972) at I.R.C. § 643.

Editor's Note: The Tax Reform Act of 1984 was signed into law by President Reagan on July 18, 1984. Section 82 of this Act codified the Treasury Regulations as mentioned above into law, thus negating the Tax Court's precedent in the *Stephenson* case.

16. *Temporary Regulations — S Corporations*

The Subchapter S Revision Act of 1982¹ made numerous changes in rules affecting Sub S corporations. Some of these changes are explained in recently issued temporary regulations. Basically, the regulations clarify the election, termination of status, and taxable year features of S corporations.

Election

To make an S corporation election, an authorized person² must sign and file the appropriate form.³ Each shareholder's consent to the election must appear on or be attached to the form. If a separate statement is used to show consent, it must include the name, address, and taxpayer identification number of the corporation and shareholder. The number of shares owned and the stock acquisition date or dates must also be included.⁴

For a proper election to be made, the shareholder's consent must be given at the time the election is made.⁵ In addition, consent must also be given by anyone who was a shareholder at any time during the taxable year prior to the election, but who was not a shareholder at the time of the election, if the election is made within the corporation's first taxable year for which it is effective.⁶ Special rules apply to consent involving stock ownership by community property spouses, minors, trusts, and estates.⁷

The time for filing the election must be either during the immediately preceding tax year for which the election is to be effective or before the sixteenth day of the third month during the taxable year for which the election is to be effective.⁸ Under prior law the election could be made either during the preceding tax year or during the first seventy-five days of the taxable year for which the election was to be effective.⁹ Certain late or otherwise defective elections will be treated as being made for the next taxable year.¹⁰

Requirements for a qualified Subchapter S trust election are slightly different. A trust election must be filed either within sixty-one days from the date a corporation's stock is transferred to a trust or during the first sixty-one days of the taxable year in which the election is to be effective, whichever is later.¹¹

¹Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

²Temp. Reg. § 18.1362-1(a) (1983) (providing that for purposes of an S corporation election, an authorized person is any person who is authorized to sign the return required to be filed under Section 6037).

³*Id.* (Form 2553).

⁴Temp. Reg. § 18.1362-2(a) (1983).

⁵However, Temp. Reg. § 18.1362-2(c) (1983) provides an extension of time for filing consents.

⁶Temp. Reg. § 18.1362-2(b)(1) (1983).

⁷Temp. Reg. § 18.1362-2(b)(2) (1983).

⁸Temp. Reg. § 18.1362-1(b) (1983).

⁹I.R.C. § 1372(c) (1982).

¹⁰Temp. Reg. § 18.1362-1(b) (1983).

¹¹Temp. Reg. § 18.1361-1(a)(4) (1983).

The commissioner's consent is required to revoke this type of election.¹² For successive income beneficiaries, the election will be automatic unless an affirmative refusal to consent is made.¹³

Termination

Revocation of S corporation status can only be made when shareholders holding a majority of all issued and outstanding stock consent to such revocation.¹⁴ The corporation must file a revocation statement which must be signed by an authorized person. In addition, a statement of consent to the revocation signed by each consenting shareholder must be attached to the corporate revocation statement.¹⁵ Under prior law, the consent of all shareholders was required to revoke S corporation status.¹⁶

For the termination year, the corporation can elect to avoid a Section 1362(3)(2) pro rata allocation (of short taxable year items) if everyone who was a shareholder at anytime during the corporation's termination year so consents. An election statement must be filed and must state the cause and date of termination. Shareholder consent statements must be attached to the election statements.¹⁷

The temporary regulations provide a new termination option not previously available. If a shareholder terminates his entire interest in an S corporation, the corporation can elect to treat the taxable year as two short taxable years.¹⁸ By electing to treat part of the taxable year as an S short year and the other part as a C short year, the corporation can initiate a pro rata distribution as of the day the shareholder terminates his interest.¹⁹ Once again, all persons who were shareholders at any time during the taxable year must consent. A statement of consent, signed by the shareholders, must be attached to the election statement to be filed by the corporation.²⁰

Taxable Year

Under prior law, a Subchapter S corporation could choose any accounting year that a regular corporation could choose. However, under the new temporary regulations only a calendar year can be used as the taxable year unless a corporation can establish a business purpose for having a different taxable

¹²Temp. Reg. § 18.1361-1(c) (1983).

¹³Temp. Reg. § 18.1361-1(b) (1983).

¹⁴Temp. Reg. § 18.1362-3 (1983).

¹⁵*Id.* The statement of consent must also include the number of issued and outstanding shares of stock held by each consent shareholder at the time the revocation is made.

¹⁶Treas. Reg. § 1.1372-4(b)(2) (1976).

¹⁷Temp. Reg. § 18.1362-4 (1983).

¹⁸Temp. Reg. § 18.1377-1 (1983).

¹⁹A pro rata distribution is permitted by Section 1377(a)(1).

²⁰Temp. Reg. § 18.1377-1 (1983). The election statement choosing the treatment of the taxable year as two short tax years must also include the manner and date of termination.

year.²¹ Thus, a corporation cannot elect S corporation status unless its taxable year is a calendar year or it has established a business purpose for using a different taxable year.

A corporation considering electing S corporation status may qualify for an automatic change of its taxable year. To qualify, all principal shareholders²² must have as their taxable year a calendar year or must concurrently change their taxable year to a calendar year.²³ If this qualification is met, a corporation's taxable year will be automatically changed to a calendar year upon the filing of an S corporation election.²⁴

The procedure is more complicated for electing corporations that want to either retain a fiscal taxable year or adopt a fiscal taxable year. The corporation must establish a business purpose²⁵ for a fiscal taxable year and receive the commissioner's approval to use such a taxable year. The corporation must request a fiscal tax year on their election to become an S corporation.²⁶ If the request for the fiscal tax year is denied, the S corporation election will be ineffective unless the fiscal year request is accompanied by an alternative request for adoption of a calendar year if the fiscal year is denied or the Commissioner waives the requirement to file an alternate request.²⁷ If either of these two exceptions are applied, S corporation status will not be denied despite the fact that the request for a fiscal taxable year was denied. Consequently, to avoid possible delay in achieving S corporation status, corporations wishing retention or adoption of fiscal taxable year should include the additional request with the fiscal year request when filing an S corporation election.

17. *Final Regulations on Group-Term Life Insurance*

On December 1, 1983, final regulations were approved which revise the uniform premium tables used to calculate the cost for tax purposes of group-term life insurance provided by an employer to an employee. Pursuant to Internal Revenue Code Section 79(a) an employee must include in gross income that portion of the cost of group-term life insurance to the extent that the cost exceeds the cost of \$50,000 of group-term life insurance and any amount paid by the employee for the insurance. These revised tables are used to calculate the amount of premium cost to be included in an employee's gross income.

²¹Temp. Reg. § 18.1378-1(a) (1983).

²²Temp. Reg. § 18.1378-1(b)(1) (1983) provides that a principal shareholder is a shareholder having 5% or more of the issued and outstanding stock of the corporation.

²³*Id.* (however, a shareholder must first secure approval from the commissioner before changing his taxable year).

²⁴Temp. Reg. § 18.1378-1(b)(2) (1983).

²⁵Temp. Reg. § 18.1378-1(a) (1983) (a business purpose will be satisfied if it comes within the meaning of Reg. § 1.442-1(b)(1)).

²⁶Temp. Reg. § 18.1378-1(b)(2)(ii) (1983) (the request must be made on Form 2553 which is the form used to elect S corporation status, see note 3 and accompanying text, *supra*).

²⁷Temp. Reg. § 18.1378-1(b)(2)(ii)(A), (B) (1983).

¹I.R.C. § 79 (1982).

The Treasury recognized the need to update the regulations since the existing uniform premium table was based upon outdated mortality experience. Treasury Decision 7924² sets forth the criteria upon which the Treasury relied in drafting the regulations. This criteria was established by accumulating all comments made to proposed regulations previously submitted and incorporating those deemed noteworthy into the final regulations.

The revised uniform premium tables maintain the existing five-year age brackets of the previous regulations. The revised uniform tables also maintain the general form of the previous tables. The cost per \$1,000 of protection for a one-month period for the under age 30 bracket remains the same. All other age bracket amounts have been significantly reduced, especially those amounts to be used for older taxpayers.

The new uniform premium tables were based upon several assumptions. These assumptions are subject to change as more accurate information is accumulated. The Treasury has recognized that the tables may not reflect actual insurance costs but feels that the new tables reflect actual cost more accurately than did the previous tables.

The first assumption upon which the new tables are based is the most recent mortality experience published by the Society of Actuaries (1975-1979 experience). These actuarial experiences were updated to 1982 by extrapolation based upon past improvement in mortality experience. The Society of Actuaries has agreed to consider publishing mortality experience more often, thus providing current figures and making extrapolation unnecessary.³

The second assumption upon which the revised tables are based is a gender mix consisting of 85 percent male and 15 percent female employees. No comments were received to the effect that the proposed gender mix as such was inappropriate for employees receiving group-term life insurance coverage in excess of \$50,000.⁴

The final assumption made was a 10.5 percent loading charge. The loading charge is a charge made in addition to mortality costs and is deemed to be equal to 10.5 percent of mortality costs. This 10.5 percent figure was retained from the former regulations, since the Internal Revenue Service was unable

²T.D. 7924, 48 Fed. Reg. 54594 (1983).

³*Id.*

⁴*Id.*

to compile data sufficient to support a new percentage.⁵

The revised uniform premium tables are to remain in effect until the Service accumulates sufficient data to adjust its assumptions. The tables should be used for insurance provided for December 31, 1982. Because the cost per \$1,000 of protection for a one-month period has generally been reduced, the amount of group-term insurance cost includable in an employee's gross income will be correspondingly reduced. This will result in a substantial tax savings for older taxpayers who are employees receiving group-term life insurance in excess of \$50,000. The employer will not be affected by any changes in these tables, since the employer's deduction is based upon the amount of premiums paid and as such is not affected by the amount includable in an employee's gross income.

18. Section 83 Regulations Upheld

In the case of *Tilford v. Commissioner*,¹ the Sixth Circuit Court of Appeals reversed a Tax Court decision² invalidating certain Code Section 83 regulations.³ The regulations treat transfers of property by a shareholder to a corporate employee in exchange for services performed for the corporation, as a contribution of capital by the shareholder followed by an immediate transfer of the property from the corporation to the corporate employee as compensation.⁴ The question presented in *Tilford* was whether the shareholder can claim capital loss deductions for the transfer of such property to corporate employees.

Tilford was the sole shareholder and principal officer of a corporation that manufactured and sold magnetic business signs. In an effort to motivate the employees of the corporation, *Tilford* sold a portion of his stock to the employees at a price significantly below market value, retaining the right of first refusal to repurchase the stock at book value if the employees left the corporation. As a result of this transaction, *Tilford* claimed personal deductions for the loss upon the sale of the stock.⁵ The Internal Revenue Service disallowed the deductions, treating them as transfers of property in consideration for the performance of services and thus contributions of capital.⁶

The Tax Court disagreed with the Service and permitted *Tilford* to claim

¹*Id.*

²705 F.2d 828 (6th Cir. 1983).

³*Tilford v. Comm'r*, 75 T.C. 134 (1980).

⁴Treas. Reg. § 1.83-6(d) (1978) (pertaining to certain transfers by shareholders. However, at the time of the trial and briefing in the Tax Court, the relevant regulations were published in proposed form but were later finalized prior to the writing of the Tax Court opinion.)

⁵Treas. Reg. § 1.83-6(d)(1) (1978).

⁶I.R.C. § 1002 (providing for recognition of gain or loss upon the sale or exchange of property, repealed 1976).

⁷705 F.2d at 829.

the loss deductions.⁷ In invalidating the relevant regulations as outside the scope of Section 83,⁸ the Tax Court maintained that Section 83 dealt primarily with the “recognition of income under certain restricted stock compensation plans.”⁹ To strengthen their invalidation, the Tax Court also asserted that the regulations in question were “contrary to the express terms of the Code.”¹⁰

The Court of Appeals in reversing the Tax Court’s decision relied on the broad principle that “payments made by a stockholder for the benefit of his corporation are not deductible by the stockholder.”¹¹ Reiterating from the Tax Court dissent,¹² the Court of Appeals reasoned that the legislative purpose of Section 83 was to provide broad coverage of compensatory sales of property rather than limiting the scope of coverage to restricted stock compensation plans.¹³ The Court points out that Congress would not have described the deduction recipient as “the person for whom were performed the services” if they had meant merely to cover a bargain sale by an employer to an employee.¹⁴ Thus, the scope of Section 83 did not preclude the inclusion of the relevant regulations.

In interpreting Section 83, the *Tilford* transaction could be viewed as one of two types. It could be viewed as a simple sale in which the shareholder sells his stock directly to the corporate employee¹⁵ or as a transfer of stock to the corporation then a subsequent transfer from the corporation to the employee.¹⁶ The Court rejected the simple sale view and held that the sale must be considered a contribution to the capital of the corporation and subsequently as compensation paid out to the employees.¹⁷ As a result of this view, the corporation would be able to claim a deduction for its deemed payment of compensation,¹⁸ and the employees must claim the received compensation as income.¹⁹ In addition, the shareholder cannot claim a loss deduction.

⁷75 T.C. 134.

⁸*Id.* at 145.

⁹*Id.* at 144.

¹⁰*Id.* at 145.

¹¹705 F.2d at 830.

¹²705 F.2d 828 (The Court relied heavily on the dissenting opinion of Judge Simpson).

¹³*Id.* at 830. (The Court looked at § 83(a), which sets forth the general rule of taxability for property transferred in connection with performance of services).

¹⁴*Id.* (citation omitted).

¹⁵*Id.* at 830-831.

¹⁶*Id.* at 831.

¹⁷*Id.*

¹⁸I.R.C. § 162(a)(1) (1982) provides for a deduction to a corporation (or individual) for “reasonable compensation for personal services actually rendered.”

¹⁹I.R.C. § 61(a)(1) (1982) provides that compensation received for services whether paid in cash or in kind must be stated as income.

19. *New Regulations Revise Actuarial Tables and Interest Factors*

In 1983, the Internal Revenue Service issued proposed amendments to the tax regulations that contain actuarial and valuation tables, which are now based upon a ten percent discount and income factor rather than the previously existing six percent factor. The proposed regulations¹ are also gender neutral in that they present tables based upon unisex mortality rates.² The Service has stated that it will periodically re-examine market interest rates and revise the tables to reflect changing rates as the need arises.

These amendments will affect existing regulations to income tax I.R.C. Sections 52, 170, 642 and 664; regulations under estate tax I.R.C. Sections 2031 and 2055; regulations under gift tax I.R.C. Sections 2512, 2522 and 2523; and the temporary income tax regulations under the Employee Retirement Income Security Act of 1974 under I.R.C. Section 414. Thus, these amended regulations will have far reaching effects in many areas of tax practice. These effects can be readily observed by comparing the tax consequences resulting from use of the current six percent tables and the proposed ten percent tables. The new tables will result in higher values being placed on life and term interests. Remainders, reversions, and annuities will have lower values.

In May of 1984, the revised actuarial tables were adopted as final regulations and are generally effective for transfers occurring after November 30, 1983.³ Transitional rules allowing use of rates less than 10% were also adopted respecting pooled income funds and certain testamentary trusts.

20. *Backup Withholding Legislation*

The Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter TEFRA) set forth provisions for mandatory withholding of income tax at a ten percent rate on interest, dividends, and patronage dividends paid or credited after June 30, 1983, to individuals and unincorporated entities.¹ If a payee failed to furnish a taxpayer identification number (hereinafter "TIN") to the payor, or the payor had been notified by the Internal Revenue Service that the TIN provided by the payee was incorrect, TEFRA allowed for backup withholding at a rate of fifteen percent.

In response to the enormously unfavorable reaction of taxpayers, Congress repealed these mandatory withholding provisions in the Interest and Divi-

¹48 Fed. Reg. 50087 (1983).

²Making the tables gender-neutral is consistent with recent case law that restricts the use of sex-based actuarial factors in various contexts. See *Arizona Governing Committee v. Norris*, 103 S.Ct. 3492 (1983), discussed in Part I of this article; and note *Manufacturers Hanover Trust Co. v. U.S.*, 52 A.F.T.R. 2d (P-H) ¶ 148,611, in which the Court found the application of gender-based tables to be unconstitutional in valuing a reversionary interest under Section 2037.

³T.D. 7955, 1984-23 I.R.B. 4.

¹Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

dividend Tax Compliance Act of 1983² and inserted a new backup withholding system.³ The new withholding system will apply to all “reportable payments”⁴ made after December 31, 1983. Reportable payments are defined to include any reportable interest or dividend payments.⁵

Under the new law, a payor is required to deduct and withhold income tax from a reportable payment at a rate of twenty percent if:

- (1) the payee does not furnish his TIN to the payor in the manner required;⁶
- (2) the Secretary notifies the payor that the TIN the payee furnished is incorrect;⁷
- (3) there has been a notified payee underreporting as described in I.R.C. Section 3406(c);⁸ or
- (4) there has been a payee certification failure as described in I.R.C. Section 3406(d).⁹

Section 3406 provides three general exceptions to the application of its backup withholding provisions:¹⁰ 1) payments to organizations and governmental units as defined in Section 6049 (b)(4)(B), (C), (D), (E), or (F) and other persons as specified in the regulations;¹¹ 2) amounts for which withholding is otherwise required;¹² and 3) those persons awaiting the receipt of a TIN.¹³

Section 3406 also provides for confidentiality of information obtained by payors about payees.¹⁴ Specifically, the information may not be used for any purpose other than meeting the requirements of Section 3046 as for purposes allowed in Section 6103.¹⁵

The Internal Revenue Service has issued temporary regulations regarding backup withholding in the form of questions and answers.¹⁶ These regulations principally concern the due diligence exception to the penalty on payors of reportable interest or dividend payments for failure to provide the payee’s correct

²Pub. L. No. 98-67, 97 Stat. 369 (1983).

³I.R.C. § 3406 (1982).

⁴I.R.C. § 3406(b)(1) (1982).

⁵I.R.C. § 3406(b)(2) (1982).

⁶I.R.C. § 3406(a)(1)(A) (1982).

⁷I.R.C. § 3406(a)(1)(B) (1982).

⁸I.R.C. § 3406(a)(1)(C) (1982).

⁹I.R.C. § 3406(c)(1)(D) (1982).

¹⁰I.R.C. § 3406(g) (1982).

¹¹I.R.C. § 3406(g)(1)(A) and (B) (1982).

¹²I.R.C. § 3406(g)(2) (1982).

¹³I.R.C. § 3406(g)(3) (1982).

¹⁴I.R.C. § 3406(f) (1982).

¹⁵*Id.* Section 6103 is entitled, “Confidentiality and Disclosure of Returns and Return Information.”

¹⁶Treas. Reg. § 35a.9999-1 (1983).

taxpayer identification number on certain information returns or comply with the certification requirements in connection with backup withholding under the Interest and Dividend Tax Compliance Act of 1983.

The Internal Revenue Service has also issued Form W-9, Payor's Request for Taxpayer Identification Number, to assist payors in obtaining correct TINs from the taxpayer. For accounts opened before 1984, the form is used to obtain the certification by the payee that his TIN is correct. For accounts opened after 1984, the form is used to obtain the payee's certification that his TIN is correct and that he is not subject to backup withholding.

21. *Amended Regulations for Return Filing Extensions*

Regulations relating to automatic extensions for filing tax returns were recently amended for both corporate and individual taxpayers.¹ The corporate extension period, formerly three months is now six months, and the individual extension period, formerly two months, is now four months.² These changes are effective for taxable years ending on or after December 31, 1982.³

The amended regulations provide similar requirements for corporations and individuals respecting application for an extension. A corporate extension is sought by filing an "Application for Automatic Extension of Time to File U.S. Corporate Income Tax Return," which is Form 7004.⁴ Similarly, an individual files a Form 4686, labeled "Application for Automatic Extension of Time to File U.S. Individual Tax Return."⁵ Both the corporate and individual forms must be signed. In the case of an individual, the form can be signed by either the individual taxpayer or a person authorized by the individual to act on his behalf.⁶ The corporate extension must be signed by a person who is authorized by the corporation to request such an extension.⁷

The amended regulations require that the corporate and individual extension forms be filed with the same Internal Revenue Service office with which taxpayers are required to file their income tax returns.⁸ The extension form must be filed on or before the due date for filing the income tax return.⁹ The form must indicate the amount of tax properly estimated for the period and payment for such must be remitted with the extension application.¹⁰ Accordingly, the automatic extension extends only the time for filing the taxpayer's

¹T.D. 7885, 1983-1 C.B. 338.

²*Id.*

³*Id.*

⁴Treas. Reg. § 1.6081-3(a)(1) (1978).

⁵Treas. Reg. § 1.6081-4(a)(2) (1978).

⁶*Id.*

⁷Treas. Reg. § 1.6081-3(a)(1) (1978).

⁸Treas. Reg. §§ 1.6081-3(a)(2) and 1.6081-4(a)(3) (1978).

⁹*Id.*

¹⁰Treas. Reg. §§ 1.6081-3(a)(3) and 1.6081-4(a)(4) (1978).

income tax return and does not extend the time period for paying the tax that is estimated to be due.

The amended regulations also provide an automatic six month filing extension for certain United States citizens traveling or living outside of the United States or Puerto Rico.¹¹ Persons eligible under this provision are defined in Treasury Regulation Section 1.6081-4.

A statement must be attached to the return verifying that the person for whom the return is made is a person described under the regulations.¹² An important distinction between this provision and the provisions applicable to persons who do not venture abroad is that this provision also extends the time for payment of taxes.¹³

IV. INCOME RECOGNITION AND RELATED TOPICS

22. *Partial Recourse Notes — Determination of Basis*

Prior to Revenue Ruling 82-224,¹ guidelines were uncertain as to what portion of a partial recourse note would be considered as basis for purposes of depreciation and investment credit allowances for property acquired by an investor. Generally, basis in acquired property will be its cost.² However, this may not be true, if an investor acquires property secured by a partial recourse note in which payments on the note are first applied to the recourse portion and in the event of default, the collateral securing the note is also first applied to the recourse portion. In such situations, the partial recourse note will be treated as two separate obligations.³ One will be considered recourse, the other non-recourse.

Unless the investor can demonstrate that the fair market value of the property securing the note is of sufficient value to support both the recourse and non-recourse obligations, the portion treated as a non-recourse obligation will not be considered in determining the investor's basis in the acquired property.⁴ In addition, the entire portion of the partial recourse note deemed to be the recourse obligation may not be considered in determining basis if part of the recourse obligation is treated as unstated interest and not as principal.⁵ If this is the case, then only the present value⁶ of the recourse obligation will be considered in determining basis.

¹¹Treas. Reg. § 1.6081-2(a) (1980).

¹²*Id.*

¹³Treas. Reg. § 1.6081-1(a) (1979).

¹Rev. Rul. 82-224, 1982-2 C.B. 5.

²I.R.C. § 1012 (1982).

³Rev. Rul. 82-224, 1982-2 C.B. 5.

⁴*Id.* at 7.

⁵See I.R.C. § 483(a) (1982) in which unstated interest is recognized for tax purposes.

⁶Treas. Reg. § 1.483-1(g) (1981).

23. *Preferred Stock Recapitalizations — Valuation of Preferred Stock*

During the past decade, one of the most serious impediments in passing ownership of a closely-held corporation from the older to the younger generation has been the devastating effects of inflation and the growth of the company upon estate taxes. In an attempt to solve this problem, estate planners have engaged in “estate freezing” techniques. In the broadest interpretation, an estate or asset freeze includes any transaction whereby the older generation owns assets with a fixed value which will remain constant over the remainder of their lives, while the younger generation possesses an interest in the business which receives all or most future appreciation. It should be noted that although the older generation is interested in diverting the future growth of the business to the younger generation, the older generation usually does not want to relinquish control.

Historically, one of the most popular techniques to achieve these goals is a corporate recapitalization. The recapitalization involves conversion of the older generation’s common stock into preferred voting or preferred nonvoting stock. The older generation then retains the preferred voting stock and gives the preferred non-voting stock to children not involved in the business. The remaining common stock is owned by the children working in the business.

The common stock owned by the children working in the business receives the benefits of future appreciation. Although the common stock has voting rights, the number of shares may be substantially less than the number of preferred voting shares held by the parents. Therefore, the older generation is assured of the control of the corporation until such time as they choose to relinquish it. In 1983 the Internal Revenue Service issued Revenue Ruling 83-120,¹ which deals with the valuation of preferred and common stock resulting from a corporate recapitalization. Although the Revenue Ruling is structured to deal with the valuation of a gift that might occur at the time of the recapitalization, the elements determining value have equal applicability for other tax purposes.

The asset value freezing techniques recognize that stock ownership is, in reality, a bundle of legal rights and that each right can be valued and transferred within a family unit, ideally with minimal gift, estate, and income tax ramifications. These rights are:

1. Income — the right to the present and future income produced by the entity.
2. Present equity — the right to the current fair market value of the stock or the current net worth of the business on liquidation.
3. Future appreciation — the right to the speculative possibility of growth in the value of the business.

¹Rev. Rul. 83-120, 1983-2 C.B. 170.

4. Control — the right to vote in the management of the business and the activities associated with it.

The factors set forth by Revenue Ruling 83-120, which amplifies Revenue Ruling 59-60, for determining the value of preferred and common stock, will normally result in the preferred stock having a fair market value substantially less than its par value. The corollary of this result is that the common stock will have a value substantially greater than would normally be expected. As a result, when the common stock is passed to the younger generation, a taxable gift may result.

The most important factor in determining the value of preferred stock is the adequacy of the dividend.² If the actual fair market value of the preferred stock is to be equal with the par value, then the dividend that the closely-held company is paying must be comparable with dividends paid on high-grade publicly traded preferred stock. If the closely-held corporation is required to pay an interest rate on borrowings in excess of the prime rate, then Revenue Ruling 83-120 suggests that the same premium be added to the dividend rate paid on its preferred stock. If the yield on the preferred stock does not pass this comparability test, then the true value of the preferred stock will be substantially less than the par value.

Although the dividend rate actually stated is assumed to be the yield on the preferred stock, an examination must be made into the adequacy of the company's earnings to determine whether the company will be able to pay such a rate. Dividend coverage is determined "by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."³

It is important that the company not only have the earnings capacity, but also the intention to pay the stated dividend rate. Past earnings will be analyzed to see if on a historical basis there is adequate coverage for the stated dividends.

If the stock is cumulative, the value of the preferred stock will be enhanced. Typically, a non-cumulative provision will be included in the preferred stock, since any unpaid dividends are subject to estate tax at the death of the preferred stockholder.

Another aspect of the valuation is whether the corporation will be able to pay the full liquidation preference at the time of liquidation.⁴ This can be measured by the amount of the corporation's net assets. As with the dividend rate, the coverage of net assets for liquidation is also to be compared to that of high quality, publicly traded preferred stock. If the asset protection is inadequate, the value of the preferred stock is less than its par value.

²*Id.*

³*Id.*

⁴*Id.*

The ability to vote the preferred stock and thus maintain control of course enhances its value.⁵ Although the preferred stock may have voting control, if the state law provides special protection for common shareholders, the value of the common stock may be enhanced as well.

The Revenue Ruling points out that the value of common stock is determined in relation to the various rights it possesses.⁶ If the common stock is to be the beneficiary of all future earnings, then it has a substantial value. The extent of this valuable right is determined by the company's past growth experience, the industry's economic condition, and the general economic conditions of the country. If at the time of the recapitalization the company has earnings in excess of the preferred dividend coverage, the common stock becomes more valuable. This is particularly true if the company has a history of reinvesting its earnings rather than paying them out as dividends.

Revenue Ruling 83-120 will cause tax and estate planners to seriously question the commonly used technique of stating a high dividend rate on preferred stock and then paying a rate substantially less or no dividend at all. The result of violating the principles set forth in this revenue ruling will have an immediate tax result, since the recapitalization will result in a gift to the common shareholders by the amount that the par value of the preferred stock exceeds its actual fair market value.

This revenue ruling may result in increased interest in the "partnership freeze" technique. A partnership technique may be preferred because the return paid to the frozen "preferred" interest is not subject to double taxation as are the dividends paid to preferred shareholders. In all probability, very few closely-held corporations will be able to pay the high dividends that Revenue Ruling 83-120 requires.

24. *Preferred Stock Recapitalizations — Excess Redemption Premium*

Revenue Ruling 83-119¹ provides that, where there is a provision for the redemption of preferred stock received in a recapitalization at the death of the holder of the preferred stock, any redemption premium in excess of 10% of the initial fair market value of the preferred stock is ordinary income. This income is treated as constructively received pro rata over the shareholder's life expectancy.

A recapitalization is an arrangement whereby a corporation's capital structure is realigned to accomplish certain objectives. If the readjustment qualifies as a recapitalization within the meaning of Section 368(a)(1)(E), no gain or loss occurs if the principal amount of securities received does not exceed the amount

⁵*Id.*

⁶*Id.*

¹Rev. Rul. 83-119, 1983-2 C.B. 57.

of securities surrendered.² Any excess stock distribution could result in the realization of income to the shareholder. However, gross income does not generally include stock distributions unless one of the Section 305(b) or (c) exceptions apply.³

The following example of a recapitalization, taken from Revenue Ruling 83-119, enables a better understanding of the events and motives for this type of reorganization. Domestic corporation "X" has outstanding 100 shares of common stock. "A" owns 80 shares of this common stock and is the president of the corporation. "B", the son of A, and the person who will be taking over the management of the company, owns the remaining 20 shares. A's objectives are to retire from any future involvement in X and to transfer control to his son. Pursuant to a recapitalization plan, a single class of \$1,000 par value, non-voting preferred stock is authorized. The plan requires that upon A's death the company has to redeem the preferred stock at its par value, \$1000, from A's estate. A exchanges his 80 shares of common stock, which have a value of \$1,000, for 80 shares of new preferred. After the exchange, B is in control since he owns all of the common voting shares of the company.⁴

Both A and B presume the recapitalization to be a tax-free, one-for-one exchange based on the premise that 80 shares of \$1,000 fair market value common were exchanged for 80 shares of \$1,000 par value preferred stock. However, at the time of the recapitalization, the preferred stock only has a fair market value of \$600 per share. The result of the exchange is that at A's death, X corporation will redeem the preferred stock in an amount in excess of its issue price.⁵

The general rule of Section 305(a) is that no income results from a recapitalization. Distributions of preferred stock however, are an exception. Preferred stock distributions that increase a shareholder's proportionate interest in the earnings or assets of the corporation are considered a distribution of property. Such a distribution occurs when preferred stock is redeemed after a specific period of time at a price higher than the issue price of the preferred stock.⁶ Nevertheless, not all of the excess redemption amount will be a distribution of property because a redemption premium is permitted if reasonable. A redemption premium is "reasonable" if it is in the nature of a penalty for a premature redemption of the preferred stock and if such premium does not exceed the amount the corporation would be required to pay for the rights to make a premature redemption under market conditions existing at the time of issuance.⁷ A redemption premium safe harbor exists if the redemption

²I.R.C. § 354 (1982).

³I.R.C. § 305(a) (1982).

⁴Rev. Rul. 83-119, 1983-2 C.B. 57.

⁵*Id.*

⁶Treas. Reg. § 1.305-5(b)(1) (1974).

⁷Treas. Reg. § 1.305-5(b)(2) (1974).

premium does not exceed ten percent of the issue price of stock not redeemable for five years from the date of issuance.⁸

Recapitalizations are only taxable if a distribution is deemed to occur. Certain transactions are deemed to be distributions under Section 305(c). These deemed distributions may even occur in isolated transactions, if the transaction is pursuant to a plan to increase a shareholder's proportionate interest periodically.⁹ This "plan" is not found in our example. The only "plan" in corporation X was to transfer corporate control.

Although the recapitalization itself is not part of a plan to increase a shareholder's proportionate interest, other factors may cause the transfer to become a taxable distribution of property. In our example these factors are the difference in issue price and redemption price and the fact that the stock cannot be redeemed until a specific date. During the period in which the preferred stock is not redeemable, A's interest is being slowly increased and thus such increase causes the "deemed distribution". Note, however, that a "deemed distribution" does not exist when the excess between issue price and redemption price is a reasonable redemption premium.¹⁰

The "deemed distribution" will be considered constructively received by A during the period between issuance and redemption. The amount of distribution is the amount by which the redemption price exceeds the issue price plus the ten percent safe harbor redemption premium. This amount will be included in A's income ratably, using A's life expectancy at the specific redemption date. If A dies earlier, distribution income will be considered constructively received at death.¹¹ Therefore, there is income of \$340 (\$1000 - \$660) over 24 years, using A's assumed age, at \$14.17 per year.

This "deemed" distribution could have been avoided had a true one-for-one exchange transpired, that is, if the total fair market value of the newly authorized and issued preferred stock had been given in exchange for an equal amount of the surrendered common stock. Respecting a related problem, Revenue Ruling 83-120¹² provides factors that should be considered when valuing stock.

25. *Stock Sale Income Deferral Through Use of Escrow Arrangement*

*Reed v. Commissioner*¹ reverses a Tax Court decision that upheld a deficiency based upon the taxpayer's attempt to defer recognition of income. The

⁸*Id.*

⁹Treas. Reg. § 1.305-7(c) (1973).

¹⁰Rev. Rul. 83-119, 1983-2 C.B. 57.

¹¹*Id.*

¹²Rev. Rul. 83-120, 1983-2 C.B. 170.

¹723 F.2d 138 (1st Cir. 1983).

Court of Appeals for the First Circuit held that a purchase-sale agreement² which deferred the payment of the purchase price of stock by use of an escrow arrangement, enabled the seller to shift income recognition by the seller until the taxable year when the purchase price was actually received.

The Court permitted the intended deferral of income because, as stated in the conclusion to its opinion, the escrow arrangement fulfilled three conditions: (1) the arrangement was part of a bona fide, arms-length agreement between purchaser and seller calling for deferred payment; (2) the seller received no present beneficial interest, such as investment income, from the escrowed sale proceeds; and (3) the escrowee was not acting under the exclusive authority of the taxpayer, and thus was not the taxpayer's agent for income recognition purposes.³ Thus, the Internal Revenue Service failed in applying three of its favorite income-recognition theories — the constructive receipt, economic benefit, and agency doctrines.

Because the IRS is unlikely to abandon these three doctrines in similar cases in other jurisdictions, an examination of the First Circuit's criteria for deferral of income recognition in a planning context may be useful.

In avoiding applications of the constructive receipt doctrine, use of a bona fide, arms-length agreement for deferred payment is essential, since the time of payment date set by such an agreement may be viewed as a "substantial limitation" on the taxpayer's control of receipt.⁴ The modification of an existing purchase-sale agreement, if such modification is bona fide and becomes binding prior to the time when the taxpayer's right to immediate payment has vested, may serve as an effective "substantial limitation."⁵ Since mutuality of the agreed deferral appears to be so vitally important, however, a seller wishing to defer payment of sale proceeds might have a better chance of withstanding a constructive receipt attack by negotiating the deferral as part of an original purchase-sale agreement that clearly references the parties' mutual interest in the deferral in the agreement's preliminary recitations.⁶

²The agreement provided for a closing on December 27, 1983, at which time the proceeds were to be paid to an independent bank, which was to release the proceeds to the selling shareholders on January 3, 1974. The sale proceeded under this arrangement, which was memorialized in writing and executed immediately prior to the December 27, 1983 closing. The basic agreement to sell was effectively in existence on November 23, 1973, when the purchaser exercised his option to purchase pursuant to a prior option agreement that was amended to set a current price per share on October 16, 1973. Thus, the escrow arrangement was a "last minute" amendment to the agreement of sale, although this final amendment also provided that the taxpayer would remain on the company's board of directors after the stock sale. *Id.* at 140-141.

³*Id.* at 149.

⁴Treas. Reg. § 1.451-2(a) (1979) states that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

⁵723 F.2d 138 at 144.

⁶A demonstration in the agreement that the deferral represents a compromise of opposing non-tax desires of the parties would no doubt be a plus. For example, the parties might wish payments made and received in different years for general accounting reasons relating to the buyer's and seller's separate financial postures. In *Reed*, the buyer's financial backer wanted the stock transaction reflected on his books for the earlier year, perhaps for some non-tax reason.

To avoid the economic benefit doctrine, a seller should forego any rights to investment income earned while the sale proceeds are in escrow. Indeed, an agreement would best be drafted so as to exclude any semblance of a present beneficial interest in the escrowed funds favoring the seller. The agreement might specifically recite that the funds cannot be assigned by the seller while in escrow and that the parties do not intend the escrowed funds to serve as present payment of the purchase price but rather intend the escrow account to serve as added assurance that payment will be made in the next year.⁷ Of course, the financial effect of such restrictions (especially foregoing interest on the fund) will assume greater importance to the seller as the proposed period of deferral lengthens.

Avoiding characterization of the escrowee as the seller's agent for purposes of income recognition is best accomplished by emphasizing in the agreement, once again, the buyer's role in the deferral. The sale agreement should refer to the buyer's authority granted to the escrowee to hold the purchase proceeds until the later distribution date. The escrow agreement itself should show that the escrowee is to act on behalf of *both* parties,⁸ and it certainly would not hurt to have the escrow fee, if any, clearly reflected as a joint expense in the closing statement to the transaction.

26. Tax Consequences of a Personal Residence Raffle

The Internal Revenue Service recently outlined in Revenue Ruling 83-130,¹ the tax consequences to taxpayers when a personal residence is sold through a raffle held by a charitable organization. Such a raffle has tax consequences to the person from whom the residence is acquired by the charitable organization, as well as the winner of the raffle.

The situation presented involved the following facts. A Mr. Miner entered into a contract with a charitable organization, Good Deed, Inc., under which Good Deed acquired a 60-day option to buy Mr. Miner's principal residence for \$100,000. Good Deed paid \$100 for the option, which if exercised would be applied towards the purchase price. The contract further provided that if Good Deed failed to sell \$120,000 in raffle tickets by the end of the 60-day period, the option would lapse, and Mr. Miner could keep the \$100.

Good Deed, Inc. sold \$200,000 worth of raffle tickets at \$100 per ticket and the option was exercised. Mr. Miner received \$99,900 for his property; the fair market value was \$100,000. Mr. Miner did not use the proceeds of the sale to purchase another principal residence. Mr. Placer won the raffle after purchasing a raffle ticket for \$100.

⁷The First Circuit Court concluded that such was the intention of the parties in *Reed*. This is true even though the decision does not mention whether the agreement of sale specifically referenced the intention of the parties in this regard. 723 F.2d 138 at 148.

⁸*Id.* at 149.

¹Rev. Rul. 83-130, 1983-2 C.B. 148.

The IRS determined that the taxable gain to Mr. Miner, the seller of the residence, would be the amount realized from the sale (\$100,000) less his adjusted basis of the property (\$30,000). The Service further stated that Mr. Miner had not made a charitable contribution to Good Deed, Inc. since the price paid by Good Deed reflected the fair market value of the residence at the time the option contract was entered into.

The amounts paid to Good Deed, Inc. by the purchasers of the raffle tickets were not contributions and thus were not deductible. The Service reasoned that taxpayers are not entitled to claim a deduction for amounts paid to a charitable organization since they receive a chance to win a valuable prize as full consideration for their contribution.²

Purchasers of losing raffle tickets are allowed a deduction only to the extent of the gains from other wagering transactions. If the purchaser is not in the trade or business of wagering, the deduction is allowable only if the purchaser itemizes deductions.³

The winner of the raffle must include in his gross income \$99,900. This figure represents the difference between the fair market value of the house and the cost of the winning ticket.

This Revenue Ruling serves as a reminder that even though a charitable organization may be involved in a transaction, the other parties involved may not be entitled to a charitable deduction for payments or value transferred to the charity.

27. Broker Reporting Requirements and Barter Income

Recent Revenue Rulings and newly issued regulations have clarified whether certain bartered exchanges result in includable income and whether information returns must be filed respecting brokered transactions.

For general tax purposes, it is clear that any type of income from any source must be included in an individual's gross income.¹ In the case of barter exchanges where the services or property of one individual are exchanged for the services or property of another individual, the person receiving the services must include the value of those services in his gross income.² However, until recently it was unclear whether a barter club member who had agreed to provide services to other members, must include the value of any services received

²Goldman v. Comm'r, 46 T.C. 136 (1966), *aff'd* 388 F.2d 476 (6th Cir. 1967).

¹I.R.C. § 165(d) (1982).

¹I.R.C. § 61 (1982), *see also* Treas. Reg. § 1.61-1 (1979) (providing that income realized in the form of money, property, or services must be included in gross income).

²Treas. Reg. § 1.61-2(d)(1) (1979), (when the services received are paid for by providing services, the fair market value of the services taken in payment must be included in gross income); *see also* Rev. Rul. 79-24, 1979-1 C.B. 60, holding that where a club directory is used to directly contact other barter club members and the value of the services are then negotiated, the fair market value of services received by the club members must be included in their gross income.

if that member had not yet provided any services in exchange. A 1983 Revenue Ruling³ clarified this question and required the inclusion in gross income, as advanced compensation of the value of services in the taxable year in which they were received. Consequently, a person joining a barter club and agreeing to provide services to other club members must include in his gross income the value of any services received, even though those services are received as advanced compensation for services yet to be rendered.⁴ The inclusion of services as advanced compensation is premised on the theory that gross income includes income received under a claim of right, not having any restrictions on its disposition, even though that income may have to be partially or fully repaid in the future.⁵

Recently finalized Regulations⁶ clarify reporting requirements for brokers and barter exchanges. In general, the new regulations treat brokers⁷ separately from barter exchanges.⁸ All "brokers" must file an information return for any sale⁹ by a customer¹⁰ unless the sale meets one of certain stated exceptions.¹¹ Thus, no information return is required for certain exempt recipients.¹² Nor is one required in situations where a broker is instructed by a registered commodities or securities dealer or a financial institution to initiate a sale.¹³ Also exempt from the filing requirement are certain sales by custodians and trustees,¹⁴ certain sales of interests in a regulated investment company,¹⁵ obligor payments

³Rev. Rul. 83-163, 1983-2 C.B. 26.

⁴In Rev. Rul. 83-163, the individuals joining the barter club agreed to provide specific services to any other member for a specified number of hours. In exchange, the joining member could demand the services of any member listed in the club directory by contacting that member directly.

⁵Rev. Rul. 83-163, 1983-2 C.B. 26, *citing* North American Oil v. Burnet, 286 U.S. 417 (1932).

⁶Treas. Reg. § 1.6045-1 (1983).

⁷Treas. Reg. § 1.6045-1(a)(1) (1983) defines "broker" as a person who in the ordinary course of a trade or business during the calendar year stands ready to effect sales involving others.

⁸Treas. Reg. § 1.6045-1(a)(4) (1983) defines "barter exchange" as any person with members or clients that contract either with each other or with such person to trade or barter property or services either directly or through such person.

⁹Treas. Reg. § 1.6045-1(a)(9) (1983) defines "sale" generally as any disposition of securities, commodities, regulated futures contracts, or forward contracts for cash, and includes redemptions of stock, retirements of indebtedness, and enterings into short sales.

¹⁰Treas. Reg. § 1.6045-1(a)(2) (1983) defines "customer" as the person (other than such broker) that makes the sale, if the broker acts as an agent, a principal, or as a participant in paying or crediting to that person's account the gross proceeds of the sale.

¹¹Treas. Reg. § 1.6045-1(c)(3) (1983).

¹²Treas. Reg. § 1.6045-1(c)(3)(i) (1983). For purposes of this exception, exempt recipients are those described in Code Section 3452(c)(2)(A) through (E) or (G) through (I). These include a corporation, tax-exempt organization, the United States or a state.

¹³Treas. Reg. § 1.6045-1(c)(3)(ii) (1983), (these are exempt under Code Section 3452(c)(2)(F) or (K) (i)). *See also* Rev. Rul. 83-123, 1983-2 C.B. 221, holding that information returns are not required of a broker when that broker receives instructions relating to a sale from a registered securities or commodities dealer or a financial institution. However, it is also noted that the dealer or financial institution would generally be required to file the information return.

¹⁴Treas. Reg. § 1.6045-1(c)(3)(iii) (1983).

¹⁵Treas. Reg. § 1.6045-1(c)(3)(iv) (1983).

on certain obligations,¹⁶ certain callable obligations,¹⁷ certain sales of foreign currency,¹⁸ certain sales of fractional shares of stock,¹⁹ and certain retirements of book entry or registered form obligations.²⁰

The regulations further provide that information returns filed by brokers must be done on a transactional basis²¹ and must include the name, address, and taxpayer identification number of the customer as well as other specified information.²² The broker must also elect a reporting period²³ and a filing group.²⁴ All of the required information returns must then be filed according to such period and filing group designations.²⁵ The regulations provide special rules governing the manner in which regulated future contracts are required to be reported.²⁶ The normal filing procedures are not to be used for sales of such nature.

The requirements for filing information returns for barter exchanges are slightly different. The difference in treatment is partially due to the differing characteristics between brokers and barter exchanges. Thus, no information returns need to be filed unless there are at least one-hundred exchanges²⁷ made through the barter exchange for any calendar year.²⁸ If this exemption is not met, the barter exchange is required to file an information return for all exchanges.

¹⁶Treas. Reg. § 1.6045-1(c)(3)(v) (1983).

¹⁷Treas. Reg. § 1.6045-1(c)(3)(vi) (1983).

¹⁸Treas. Reg. § 1.6045-1(c)(3)(vii) (1983).

¹⁹Treas. Reg. § 1.6045-1(c)(3)(viii) (1983).

²⁰Treas. Reg. § 1.6045-1(c)(3)(ix) (1983).

²¹Treas. Reg. § 1.6045-1(d)(2) (1983). Information for each sale or transaction is required on a separate form. T.D. 7873, 1983-1 C.B. 307, 308 points out that transactional reporting is necessary so that the amount received in the sale of property can be matched with the basis of the property to accurately determine gross income. In addition, most uses of the information by the Service require the information to be in the form of transactional data.

²²Treas. Reg. § 1.6045-1(d)(2) (1983). Other required information includes the property sold, the C.U.S.I.P. number (Committee on Uniform Security Identification Procedures number) if known, gross proceeds, and sale date. It should also be noted that Treas. Reg. § 1.6045-1(d)(4) provides that except for short sales, a broker may report a sale as occurring on the date the sale is entered on the books of the broker or the date the customer becomes entitled to the gross proceeds.

²³Treas. Reg. § 1.6045-1(c)(6)(i) (1983). An elected filing period may be the calendar month, quarter, or year.

²⁴Treas. Reg. § 1.6045-1(c)(6)(ii) (1983). Customers can be filed into groups according to the broker's office, branch, department, or other method of operational classification.

²⁵Treas. Reg. § 1.6045-1(c)(6)(i)(b) and (ii)(b) (1983) provides that elected filing methods can be changed upon subsequent filings.

²⁶Treas. Reg. § 1.6045-1(c)(5) (1983).

²⁷Treas. Reg. § 1.6045-1(e)(2)(i) (1983). Exchanges of properties or services are considered bartered exchanges if payment for the property or service is accomplished by a credit on the barter exchange's books, a scrip issued by a barter exchange, or direct exchanges of property or services among the barter exchange's members or clients.

²⁸Treas. Reg. § 1.6045-1(e)(2)(ii) (1983). Multiple barter exchanges may be considered as one for purposes of this requirement if it is determined that the material purpose of forming or continuing multiple barter exchange was to meet this exception.

Exchanges made by noncorporate members or clients must be reported on a transactional basis.²⁹ However, exchanges by corporate members or clients³⁰ can be reported on an aggregate basis.³¹ These returns must include the name, address, and taxpayer identification number of the member or client providing the property or services in the exchange as well as other information.³² Unlike the reporting period election provided to brokers, barter exchanges have no election and must use the calendar year as the reporting period.³³

With respect to both brokers and barter exchanges the regulations set forth rules concerning the time and place for filing,³⁴ the furnishing of statements³⁵ and the manner in which the information should be filed.³⁶ In addition, the regulations provide that the customer is identified by the name that appears on the books and records of the broker or barter exchange.³⁷ The regulations also provide that no information return need be filed if the participating member, client, or customer is an exempt foreign individual.³⁸

28. Like-Kind Exchange Treatment for Serialized Exchanges

Section 1031¹ of the Internal Revenue Code provides for nonrecognition of gain or loss if property held for use in a trade or business or held for investment is exchanged solely for like-kind property to be held for use in a trade or business or held for investment. In *Garcia v. Commissioner*,² the Court held that an exchange of residential real property held for investment effected by a series of transactions involving four parties, three properties, and three inter-related escrow agreements, was a qualifying exchange for nonrecognition of

²⁹Treas. Reg. § 1.6045-1(f)(2)(i) (1983).

³⁰Treas. Reg. § 1.6045-1(f)(2)(ii) (1983) defines a corporate member or client as a corporation defined in code section 7701(a)(3) and includes a pool, syndicate, partnership or unincorporated association composed exclusively of corporations.

³¹Initially, all barter exchange information returns were required to be reported on a transactional basis; see T.D. 7873, 1983-1 C.B. 307, 314. However, the regulations were subsequently amended to permit aggregate reporting for corporate members or clients in order to reduce the reporting burden on barter exchanges; see T.D. 7932, 1984-6 I.R.B. 8. Aggregate reporting permits the barter exchange to aggregate all exchanges received or provided by a corporate member or client on one information return form instead of using numerous forms for each individual transaction.

³²Treas. Reg. § 1.6045-1(f)(2)(i) and (ii) (1983). Additional information includes the property or services provided, the amount received by the member or client for such property or services, and the date on which the exchange occurred. For aggregate reporting the amounts are aggregated into a single figure for the entire reporting period.

³³Treas. Reg. § 1.6045-1(f)(6) (1983).

³⁴Treas. Reg. § 1.6045-1(j) (1983).

³⁵Treas. Reg. § 1.6045-1(k) (1983).

³⁶Treas. Reg. § 1.6045-1(l) (1983). Information returns should be filed on magnetic media unless excepted by undue hardship.

³⁷Treas. Reg. § 1.6045-1(h) (1983).

³⁸Treas. Reg. § 1.6045-1(g) (1983).

Editor's Note: Treasury Regulation § 1.6045-1(c)(3) was amended by the IRS in a temporary rule filed May 23, 1984. See Temp. Reg. § 5f.6045-1 (1984).

¹I.R.C. § 1031 (1976).

²80 T.C. 491 (1983).

gain under Section 1031.

The taxpayers in *Garcia* were the owners of residential real property held as rental property. Taxpayers, wishing to dispose of this property and at the same time take advantage of the nonrecognition provisions of Section 1031, found a buyer, F, who was willing to cooperate with them in arranging a series of transactions. Taxpayers and F established an escrow account and escrow agreement A, to accommodate the sale of the taxpayer's property to F, and F agreed to cooperate in finding suitable exchange property for the taxpayers. The escrow agreement provided that F could terminate the agreement if suitable property was not found within sixty days.

Suitable property for the exchange, belonging to H, was found. H was willing to cooperate in the transfer but also wanted to take advantage of the nonrecognition provisions of Section 1031 by exchanging his property for property owned by G. In order to effect these transfers and accommodate all parties involved, two additional escrow accounts, B and C, were established. In addition, to eliminate the possibility of boot being realized in the transaction, the escrow agreements provided that H was to secure a new deed of trust in the amount of \$107,200, to equalize the liability to which the taxpayer's property was subject at the time of transfer.

All of the escrow agreements involved referred to the taxpayers' intent to effect an exchange of their property to obtain the benefit of Section 1031. All of the agreements were subject to and conditioned upon the simultaneous closings of all escrow accounts. All escrow accounts were closed simultaneously, the end result being that taxpayers received title to the property formerly owned by H subject to deeds of trust in the amount of \$107,250.

Taxpayers reported no taxable gain on their income tax return for the year these exchanges were effected. The Internal Revenue Service contended that the exchanges constructed by taxpayers did not qualify for nonrecognition of gain under Section 1031 and that a gain of approximately \$101,994 was to be recognized by taxpayers. The Service argued that the transactions involved a sale of taxpayers' property followed by a reinvestment of the proceeds. Alternatively, the Service contended that the taxpayers constructively received the cash transferred by F to escrow account A and thus received taxable boot in the exchange.

The Court first considered the applicability of the nonrecognition provisions of Section 1031 to the transaction. The Court looked to the parties' intent and found, pursuant to the escrow agreements, a stated desire for nonrecognition exchange treatment. It found that the parties to the transaction took steps consistent with this expressed intent and did, in fact, effect a proper exchange transaction. To support its analysis, the Court cited *Biggs v.*

*Commissioner*³ and *Starker v. United States*,⁴ which involved similar findings under Section 1031 in situations involving multi-party exchanges.

The Court also analyzed the transaction to see if any boot was received by the taxpayers, since recognition results to the extent that other than like-kind property is received. The key inquiry focused on the deposit of cash by F into the A escrow account with respect to the purchase of taxpayers' property. The Court found that taxpayers did not actually or constructively receive the cash at any time while the transfers were effected, since "substantial restrictions" were placed on these monies by the escrow agreements. In addition, F, the purchaser, had a right to cancel the agreement if suitable property was not found within sixty days. Thus, no party had any right to withdraw these funds during that time. Finally, at the time the transfer was actually made, H had been substituted for taxpayers as seller of the parcel, and, thus taxpayers were not parties to the contract. The Service asserted that H was merely acting as taxpayers' agent, but the Court rejected this argument citing *Alderson v. Commissioner*⁵ and stating that "One need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property."⁶

The Service also challenged nonrecognition treatment on the basis that no reference was made as to a required purpose for the earnest money deposited by F into escrow A. The Court rejected this argument based upon the parties' overlying intention to effect a proper exchange. Additionally, the escrow accounts were to be closed simultaneously and were subject to and conditioned upon each other. The Court stated that such contractual interdependence was indicative of a proper exchange transaction. There was sufficient evidence to find an integrated plan for exchange treatment, so that the step transaction doctrine could be applied to find that a qualified exchange had occurred.⁷

Having decided that the transaction qualified for the nonrecognition provision of Section 1031, the Court addressed the issue of boot respecting the taxpayers' relief from substantial liabilities through the sale of their property. The Court found that since the liabilities assumed by the taxpayers pursuant to the deed of trust on their new property exceeded the liabilities from which they were relieved, no boot was received.

In the case of *Antonio D'Onofrio*⁸ the Tax Court held that the nonrecognition provisions of Section 1031 were inapplicable to a transaction that amounted

³69 T.C. 905 (1978).

⁴602 F.2d 1341 (9th Cir. 1979).

⁵317 F.2d 790 (9th Cir. 1963).

⁶*Id.* at 795.

⁷69 T.C. 905 (1978).

⁸52 TAX CT. MEM. DEC. (P-H) ¶ 83,632 (1983).

to a sale and reinvestment rather than an exchange. The key difference between *D'Onofrio* and *Garcia* is that although the taxpayers in both cases expressed a desire and intent to effect an exchange transaction, the taxpayer in *D'Onofrio* in effect made a sale to a third party, unrelated to the exchanging parties, and cash received from the sale was combined with property to effect the like-kind exchange. Thus, the gain recognized on the sale of property to the third party did not qualify for nonrecognition under Section 1031. In *Garcia* the proper use of interdependent escrow agreements avoided such result.