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TAXATION

INTRODUCTION

During the survey period the Tenth Circuit Court of Appeals decided several notable cases that indicate new trends in the law of federal taxation. Part I examines *O'Gilvie v. United States*,[1] which discussed the inclusion of punitive damage awards in gross income, a subject that baffles many courts. In *O'Gilvie*, the Tenth Circuit was the first to interpret *Commissioner v. Schleier*,[2] a recent Supreme Court decision clarifying the issue of punitive damages.

Several significant decisions in the survey period examined issues relating to tax liens. Part II analyzes the Tenth Circuit's decision in *Burrus v. Oklahoma Tax Commission*,[3] in which the court considered the relative priority of state and federal tax liens.[4] The court failed, however, to consider the decisions of other federal courts and may have reached an incorrect outcome. Part III reviews In re *CF&I Fabricators, Inc.*,[5] in which the Tenth Circuit considered the proper characterization of a "tax" imposed on the accumulated funding deficiency of a pension plan.[6] The characterization of this federal lien as a tax or penalty determined the priority afforded it in bankruptcy proceedings. Part IV discusses a third case focusing on federal tax liens. In re *LMS Holding Co.*[7] considered whether the Internal Revenue Service must refile to perfect a lien against corporate property purchased by another corporation as part of a liquidation plan.[8] The case required an analysis of the Uniform Commercial Code.

In the area of estate and gift tax, Part V examines *DePaoli v. Commissioner*.[9] The court analyzed the validity of a disclaimer and relevant state laws of intestacy. The *DePaoli* analysis provides an informative survey of state intestacy laws.

Finally, Part VI involves a gift revaluation by the IRS and the effect of below-market interest rates on promissory notes given in exchange for the gift. In *Schusterman v. United States*,[10] the Tenth Circuit attempted to resolve this issue, which previously had caused a split in the courts of appeals.

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1. 66 F.3d 1550 (10th Cir. 1995), *cert. granted*, 64 U.S.L.W. 3439 (U.S. Mar. 25, 1996) (Nos. 95-966, 95-977).
2. 504 U.S. 229 (1992) (reiterating the analysis first articulated in United States v. Burke, 504 U.S. 229 (1992)).
3. 59 F.3d 147 (10th Cir. 1995).
4. *Burrus*, 59 F.3d at 148.
5. 53 F.3d 1155 (10th Cir.), *cert. granted*, 116 S. Ct. 558 (1995).
6. In re *CF&I Fabricators*, 53 F.3d at 1157.
7. 50 F.3d 1526 (10th Cir. 1995).
8. In re *LMS Holding*, 50 F.3d at 1527.
9. 62 F.3d 1259 (10th Cir. 1995).
10. 63 F.3d 986 (10th Cir. 1995).

I. THE TAXATION OF PUNITIVE DAMAGES

A. *Background*

The taxation of punitive damages has a long and troubled history in federal courts.[11] Section 104(a)(2) of the Internal Revenue Code (Code) excludes from gross income amounts received "on account of personal injuries or sickness."[12] Theoretically, punitive damages should be fully taxed as income to the recipient since they serve no compensatory purpose: they fail to compensate for losses and instead result in a windfall to the injured party.[13] Because punitive damages are generally related to personal injury or sickness, however, they often are exempt from taxation. Courts construe the exact language of § 104(a)(2) differently and reach divergent results.[14]

Prior to *O'Gilvie v. United States*[15] the majority of circuit courts held that punitive damage awards should be included in gross income and subject to the federal income tax.[16] While the Supreme Court has ruled on related issues involving § 104(a)(2), the proper application of these decisions to the punitive damages dispute remains unclear.

In *United States v. Burke*,[17] the Supreme Court addressed whether the settlement of a back pay claim under Title VII of the Civil Rights Act of 1964 was gross income under § 104(a)(2).[18] In order for § 104(a)(2) to apply, the Court stated that the taxpayer must show that any award received served to redress a "tort-like personal injury."[19] The Supreme Court held that back pay

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11. For a detailed analysis on the taxation of punitive damages, see James Serven, *The Taxation of Punitive Damages:* Horton *Lays An Egg?*, 72 DENV. U. L. REV. 215 (1995).

12. Section 104(a)(2) provides:

> (a) In general.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—. . .
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness . . . .

I.R.C. § 104(a)(2) (1994). Otherwise, subject to additional exceptions, gross income includes "all income from whatever source derived." I.R.C. § 61(a) (1994).

13. Compensatory damages serve only to make the injured party whole, and, therefore, result in no income to the taxpayer, while punitive damages "are a windfall to the recipient and as such should be taxed in full." Serven, *supra* note 11, at 228-29. Under this "return of capital theory," awards that do not result in additional income to the injured party or leave him in a better position than before, should be exempt from tax. *Id.*

14. *See, e.g.*, United States v. Burke, 504 U.S. 229, 233-34 (1992); Wesson v. United States, 48 F.3d 894, 898 (5th Cir. 1995); Roemer v. Commissioner, 716 F.2d 693, 696-97 (9th Cir. 1983).

15. 66 F.3d 1550 (10th Cir. 1995), *cert. granted*, 64 U.S.L.W. 3439 (U.S. Mar. 25, 1996) (Nos. 95-966, 95-977).

16. *See, e.g.*, *Wesson*, 48 F.3d at 902; Hawkins v. United States, 30 F.3d 1077, 1084 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 2576 (1995); Reese v. United States, 24 F.3d 228, 235 (Fed. Cir. 1994); Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990). The Sixth Circuit, however, recently departed from its sister circuits when it ruled that § 104(a)(2) "does not permit a distinction between punitive and compensatory damages." Horton v. Commissioner, 33 F.3d 625, 631 (6th Cir. 1994).

17. 504 U.S. 229 (1992).

18. *Burke*, 504 U.S. at 230.

19. *Id.* at 237. Unlike lower courts, the Supreme Court made no distinction between physical

awards were not excludable from gross income because they did not compensate for a "tort-like personal injury."[20]

Following *Burke*, a number of appellate courts applied its reasoning to the issue of punitive damages taxation.[21] Only one court, the Sixth Circuit in *Horton v. Commissioner*,[22] held that § 104(a)(2) excluded punitive damages from gross income.[23] Relying on *Burke*, the Sixth Circuit found that punitive damages arising from gross negligence resulted from a personal injury and were excludable from gross income.[24]

The Supreme Court recently returned to the punitive damages issue in *Commissioner v. Schleier*.[25] In *Schleier*, the taxpayer excluded from gross income the liquidated damages from a settlement under the Age Discrimination and Employment Act (ADEA).[26] The Court reiterated the *Burke* test: not only must the claim be based on torts or tort-like rights, but it must also be personal in nature.[27]

B. O'Gilvie v. United States[28]

1. Facts

Betty O'Gilvie died of toxic shock syndrome (TSS).[29] Her husband, administrator of her estate, sued International Playtex, Inc., who manufactured the tampons O'Gilvie used when she contracted TSS.[30] The Court awarded the estate actual damages of approximately $1.5 million and punitive damages of $1.35 million.[31] The estate distributed these amounts to the beneficiaries, including the husband and children, who included the punitive damages in their gross income and promptly sued for refunds of the taxes they paid.[32] The children received refunds.[33] The district court held that in the husband's

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and non-physical injuries. *Id.* at 238. The Court established a new "scope of the remedies" analysis to determine whether "tort-like" rights are involved in the dispute. *Id.* at 234-37; *see also* Serven, *supra* note 11, at 254-60 (discussing application of the *Burke* analysis).

20. *Burke*, 504 U.S. at 241-42.

21. *See, e.g., Wesson*, 48 F.3d at 902; *Hawkins*, 30 F.3d at 1084; *Reese*, 24 F.3d at 235; *Miller*, 914 F.2d at 590.

22. 33 F.3d 625 (6th Cir. 1994).

23. *Horton*, 33 F.3d at 632.

24. *Id.* at 631-32.

25. 115 S. Ct. 2159 (1995).

26. *Schleier*, 115 S. Ct. at 2162. The taxpayer, however, did include amounts received as backpay in his gross income. *Id.* Clearly, the amounts received as back pay were not on account of personal injury or sickness. *Id.* at 2164. Any amounts which might have been received as compensation for some psychological harm, however, may have been entitled to exclusion under § 104(a)(2). *Id.*

27. *Id.* at 2167. The Court held that claims under ADEA are not tort-like and, therefore, any recoveries thereunder are not to be excluded from gross income. *Id.*

28. 66 F.3d 1550 (10th Cir. 1995), *cert. granted*, 64 U.S.L.W. 3439 (U.S. Mar. 25, 1996) (Nos. 95-966, 95-977).

29. *O'Gilvie*, 66 F.3d at 1552.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.* Two years later the IRS sued to recover these amounts as erroneous refunds. *Id.* All

case, the amounts received as punitive damages were excludable from gross income.[34] The Tenth Circuit reversed the lower court's decision.[35]

2. Decision

The court addressed four factors in its analysis.[36] First, the title of § 104, "[c]ompensation for injuries or sickness," suggests that only compensatory awards are excludable from income.[37] Second, the predecessor statute to § 104 implied that unlike compensatory damages, punitive damages are not a return of capital and are income.[38] Third, the Tenth Circuit considered the Supreme Court cases of *Burke* and *Schleier* and distinguished them from the Sixth Circuit's holding in *Horton*.[39] Finally, the court focused on the policy of narrowly construing any exclusions from income.[40]

With regard to the third factor, the Tenth Circuit noted that the *Horton* court focused solely on the punitive damages claim.[41] The Tenth Circuit found this method erroneous, since *Burke* required a more thorough analysis of the situation.[42] Thus, the *Horton* court considered the first part of the *Burke* test, but did not address whether the punitive damages were received "on account of" personal injury. The Tenth Circuit, therefore, found *Horton* unpersuasive and proceeded to define "on account of," which the Supreme Court had failed to do in both *Burke* and *Schleier*.[43]

In interpreting this phrase, the Tenth Circuit followed four other circuits, holding that punitive damage awards are taxable, and noted that the phrase "on account of" is susceptible to two interpretations. First, the phrase may describe a causal relationship in which punitive damages result from injury.[44] Second, the phrase may describe a causal relationship in which the injury itself determines the damages.[45] The Tenth Circuit looked to the legislative history of §

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parties agreed to be bound by the resolution of Kelly's suit. *Id.*

34. *Id.* at 1553.

35. *Id.* at 1560.

36. Other circuits have focused on numerous factors in making a determination as to the applicability of § 104(a)(2). These factors include: (1) the statutory context and title; (2) the principle that exclusions from income should be construed narrowly; (3) the policy and legislative history of § 104; (4) a Treasury Revenue Ruling addressing this issue; (5) the 1989 amendment to § 104(a)(2); and (6) Supreme Court cases discussing § 104 in other contexts. *Id.* at 1556.

37. *Id.* at 1558.

38. *Id.* (agreeing with the Federal Circuit's analysis in *Reese*, 24 F.3d 228). Other courts hold that the purpose of § 104 is limited to compensatory damages which make the taxpayer whole again. *Id.* Because lost wages awarded due to some physical injury are compensatory and excluded from income, the court noted that the taxpayer is made "more than whole": if she had actually worked for those wages they would be taxable income and additional tax would be payable. *Id.* at 1558-59.

39. *Id.* at 1556-57.

40. *See, e.g., Schleier*, 115 S. Ct. at 2163.

41. *Horton*, 35 F.3d at 361 ("This is the beginning and end of the inquiry."). *Id.*

42. *O'Gilvie*, 66 F.3d at 1557; *see also Schleier*, 115 S. Ct. at 2159 (supporting the Tenth Circuit's interpretation of *Burke*). *Schleier* made it clear that *Burke* should be interpreted as requiring a two-part test: first, whether the injury involved tort-type rights, and second, whether the damages were received on account of personal injuries. *Id.* at 2167.

43. *O'Gilvie*, 66 F.3d at 1557.

44. *Id.* Therefore, punitive damages would be excluded from gross income because ultimately they are awarded on account of a personal injury. *Id.*

45. *Id.* In this case, punitive damages are not excluded because punitive damages are not

104(a)(2) for the proper interpretation of this clause, particularly its 1989 amendment.[46] This examination, however, proved inconclusive.[47] Thus, the Tenth Circuit opted to follow "the default rule that exclusions from income are narrowly construed," and found for the government.[48]

3. Analysis

The Tenth Circuit's decision exemplifies the confusion over punitive damages taxation. Past congressional attempts to correct the problem have only compounded the problem, as reflected by the *O'Gilvie* decision. The Tenth Circuit's decision does not differ in substance from those of other circuit courts that have held punitive damages taxable. The decision rejects the Sixth Circuit's decision in *Horton*, thereby reaffirming the analyses and outcomes of the other courts of appeals. *O'Glivie* is also significant for its application of the Supreme Court's *Schleier* decision, as it clarified the applicable tests in punitive damages analysis.

4. Other Circuits

Since the Tenth Circuit's decision in *O'Gilvie*, the circuits, with the exception of the Sixth Circuit, favor subjecting punitive damages awards to federal taxation by five to one.[49]

II. STATE TAX LIEN PRIORITY

A. *Background*

Generally, a state tax lien merits priority in payment over a federal tax lien if it is perfected, or "choate," before the federal lien comes into existence.[50] The determination of tax lien priority represents another area of

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received based on the injuries, but rather on the unreasonable and outrageous conduct of the defendant. *Id.*

46. *Id.* at 1559. The 1989 amendment to § 104(a)(2) provides that the exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." I.R.C. § 104(a). Congress's use of the double negative has confused many courts. *See* Serven, *supra* note 11, at 260. There are several interpretations of Congressional intent in enacting this amendment and three possible results of the amendment. *Id.* at 262-66. First, punitive damages awarded in connection with non-physical injuries are now taxable while those awarded in connection with physical injuries are tax exempt. *Id.* at 262-63. Second, punitive damages are always taxable. *Id.* at 263-64. Third, Congress only spoke as to the taxability of punitive damages in fully taxable non-physical injuries and made no decision regarding the taxability of punitive damages awarded in cases involving physical injuries. *Id.* at 264-66. The Tenth Circuit stated, "We believe that using the amendment to interpret Congress' intent in 1954 (or 1918) is a questionable practice, particularly because of the long lapse of time and because the legislative history of both the original statute and the amendment are not enlightening." *O'Gilvie*, 66 F.3d at 1559.

47. *O'Gilvie*, 66 F.3d at 1560. The court noted that "good reasons tug each way" in reference to the possible interpretations of the clause based on an analysis of the legislative history. *Id.* The Tenth Circuit, however, held that a determination of which interpretation was more correct was not necessary to decide the outcome of this case. *Id.*

48. *Id.*

49. *Id.*; *see, e.g.*, *Wesson*, 48 F.3d at 902; *Hawkins*, 30 F.3d at 1084; *Reese*, 24 F.3d at 235; *Miller*, 914 F.2d at 590.

50. Burrus v. Oklahoma Tax Comm'n, 59 F.3d 147, 148 (10th Cir. 1995). The Supreme

taxation troubling the Tenth Circuit, as demonstrated by its decision in *McDermott v. Zion First National Bank.*[51]

In *United States v. City of New Britain*,[52] the Supreme Court stated that when a solvent debtor exists, a federal lien is subordinate to any prior perfected liens.[53] In that case, certain real property was foreclosed by judicial sale, the proceeds of which were insufficient to satisfy both municipal and federal liens.[54] The Supreme Court established a three-part "choateness" test to determine whether a state lien is entitled to priority over a subsequent federal lien.[55] The test states that "when the identity of the lienor, the property subject to the lien, and the amount of the lien are established," the state lien is choate.[56]

Subsequent to the *New Britain* decision, the Tenth Circuit, in *T.H. Rogers Lumber Co. v. Apel*,[57] addressed the issue of lien priority between a claim by the federal government and two mechanics' and materialmen's liens.[58] In *T.H. Rogers*, a federal claim was perfected prior to the mechanic and materialmen's liens; however, the mechanics and materialmen had commenced work on the property to which all liens attached before the federal government had perfected its lien.[59] The state lien holders argued that their liens related to the commencement of work and were entitled to priority over the federal government's claims.[60] The Tenth Circuit held that liens created under state law must be "*enforceable* by summary proceedings [to be] . . . specific and perfected on the date the federal lien was recorded."[61] Since the mechanics' and materialmen's liens were still indefinite (as to amount) and, therefore

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Court has often used the "choateness doctrine" to frustrate the priority of state tax liens. Michael D. McCullogh, Note, *When First in Time Is Not First in Right: The Supreme Court Frustrates Judgment Creditors in* United States v. McDermott, 25 LOY. U. CHI. L.J. 405, 414 (1994).

51. 945 F.2d 1475 (10th Cir. 1991), *rev'd sub nom.* United States v. McDermott, 507 U.S. 447 (1993); *see also* James Serven, *Taxation*, 71 DENV. U. L. REV. 1063 (1994); James Serven, *Taxation*, 69 DENV. U. L. REV. 1037, 1076 (1992); (discussing the Supreme Court and Tenth Circuit *McDermott* opinions). In *McDermott*, the Tenth Circuit held that a prior perfected federal tax lien did not extend to after-acquired property. *McDermott*, 945 F.2d at 1481. Predictably, the Supreme Court reversed. United States v. McDermott, 507 U.S. 447 (1993).

52. 347 U.S. 81 (1954).

53. *City of New Britain*, 347 U.S. at 87 ("[W]ith no question of insolvency involved . . . 'the first in time is the first in right.'"). *Id.* There is no question that where the debtor or estate is insolvent a claim of the federal government, whether for taxes or not, is always entitled to priority. 31 U.S.C. § 3713 (1995).

54. *City of New Britain*, 347 U.S. at 82-83. The state liens were for delinquent real estate taxes and water rent, while the federal taxes secured unpaid federal withholding and unemployment taxes, as well as unpaid insurance contributions. *Id.*

55. *Id.* at 84.

56. *Id.* If the state tax lien is choate when the federal lien is filed, then the state lien is entitled to priority. *Id.* The Supreme Court further addressed the issues in *New Britain* and determined that where a state-created lien is perfected before a federal lien, the federal lien is entitled to priority with respect to after-acquired property. *McDermott*, 507 U.S. at 455.

57. 468 F.2d 14 (10th Cir. 1972).

58. *T.H. Rogers*, 468 F.2d at 15-16.

59. *Id.* at 18-19.

60. *Id.* at 16.

61. *Id.* at 18 (emphasis added).

unperfected at the time the federal lien was perfected, the latter took priority.[62]

B. Burrus v. Oklahoma Tax Commission[63]

1. Facts

On October 7, 1986, the Oklahoma Tax Commission filed a tax warrant against Vernon V. Burrus and his wife for unpaid withholding taxes.[64] On March 23, 1989, and November 16, 1989, the IRS assessed penalties against the Burruses for unpaid taxes.[65] They subsequently sold their house, but the proceeds were insufficient to satisfy both the state and federal tax claims.[66] The IRS acknowledged that the state liens should receive priority for payment, because the state liens pre-dated those of the federal government, provided the state liens were choate when filed.[67]

The Oklahoma State Constitution provides a homestead exemption that prohibits the attachment or forced sale of a principal residence for the satisfaction of a debt.[68] Relying on *T.H. Rogers*, the federal district court added a new "enforceability" element to the *New Britain* three part test to determine the choateness of a nonfederal tax lien.[69] The district court held that because the Oklahoma homestead exemption prevented the state lien from attaching and becoming enforceable, the state lien was not entitled to priority over the federal government's claim.[70]

2. Decision

The Tenth Circuit noted that the *New Britain* test had been satisfied,[71] and rejected the district court's imposition of an additional enforceability requirement.[72] The Tenth Circuit held that the only additional element that may

62. *Id.* at 18-19.

63. 59 F.3d 147 (10th Cir. 1995).

64. Burrus v. Oklahoma Tax Comm'n, 850 F. Supp. 963, 964 (W.D. Okla. 1993), *rev'd*, 59 F.3d 147 (10th Cir. 1995). A similar warrant was recorded with respect to Mr. Burrus's wife on September 9, 1988. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. OKLA. STAT. tit. 31, § 1(A)(1) (1991). "[T]he following property shall be reserved to every person residing in the state, exempt from the attachment or execution and every other species of forced sale for the payment of debts . . . . The home of such person, provided that such home is the principal residence of such person . . . ." *Id.*

69. *Burrus*, 850 F. Supp. at 964; *see infra* note 82 and accompanying text.

70. *Burrus*, 850 F. Supp. at 965.

71. *Burrus*, 59 F.3d at 149.

72. *Id.* In rejecting this approach the Tenth Circuit stated:

> [W]e interpret T.H. Rogers to mean not that the lien must be immediately enforceable by summary proceedings at the time of filing, but rather that at the time of enforcement, whenever that should occur, a lienholder may satisfy its debt by resort to a summary proceeding because the lien will be both choate and perfected.

Id.

be necessary in proving choateness or perfection is that the lien must attach to an "identifiable piece of property."[73]

The Tenth Circuit then addressed the Oklahoma homestead exemption which provides that no debt shall "attach" to the debtor's principal residence.[74] Because the Tax Commission's lien could not attach to any identifiable piece of property, it appeared incapable of becoming choate.[75] The Tenth Circuit interpreted the word "attachment" in the Oklahoma statute to mean the physical seizure of a principal residence.[76] Therefore, the state lien could attach to the Burrus's principal residence but could not be executed.[77]

3. Analysis

The Tenth Circuit decision failed to consider the body of law, rooted in interpretations of Supreme Court opinions, recognizing the enforceability element. Two courts of appeals' decisions have addressed the issue of enforceability of a lien as a prerequisite to choateness.[78] These cases analyzed similar issues, namely, whether a state tax lien is sufficiently choate and entitled to priority over an IRS lien. The Third Circuit ruled that choateness requires enforceability.[79] That court refused to rule in favor of the IRS because the state lien was enforceable.[80] The Third Circuit relied in part on the federal district court decisions in *T.H. Rogers* and *Burrus*.[81] The Third Circuit also relied on several additional federal court decisions, many of them Tenth Circuit district court opinions.[82] Furthermore, the court cited several United

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73. *Id.*

74. *Id.*

75. *Id.* In order for perfection to occur a lien must first attach to identifiable property. With regard to attachment and perfection, see U.C.C. §§ 9-203 and 9-303 (1995).

76. *Burrus*, 59 F.3d at 150. The court noted that this is the exact harm the homestead exemption was designed to prevent. *Id.* The Tenth Circuit found this interpretation consistent with an earlier decision and a similar Kansas Supreme Court decision. *See* Tillery v. Parks, 630 F.2d 775 (10th Cir. 1980); Homestead Land Title Co. v. United States, 819 P.2d 660 (Kan. 1991). In *Homestead*, the federal district court transferred the case to the Kansas Supreme Court to determine whether a lien for unpaid sales taxes could attach to real property despite state homestead exemption. Homestead Land Title Co. v. United States, No. 90-4116-SAC, 1993 WL 360389, at *3-*4 (D. Kan. Aug. 17, 1993). The Kansas Supreme Court distinguished between the attachment of a tax lien to the homestead and the ability to force the sale of the homestead. *Id.* at *2.

77. "[A] properly filed state tax lien does 'attach' to homestead property for purposes of determining priority . . . even though it cannot be enforced at the time of filing." *Burrus*, 59 F.3d at 150.

78. Monica Fuel, Inc. v. IRS, 56 F.3d 508, 512 (3d Cir. 1995); *see In re* Terwilliger's Catering Plus, Inc., 911 F.2d 1168, 1176 (6th Cir. 1990), *cert. denied*, 501 U.S. 1212 (1991).

79. *Monica Fuel, Inc.*, 56 F.3d. at 513 ("Choateness only requires that the state have a right to enforce its lien in a summary fashion.").

80. *Id.*

81. *Id.* at 512-13. *T.H. Rogers*, as interpreted by the Tenth Circuit, only stood for the proposition that a lien must be enforceable at the time of enforcement, not at the time of filing, and of course, *Burrus* was reversed by the Tenth Circuit.

82. *See Homestead*, 1993 WL 360389, at *3; United States v. Utah State Tax Comm'n, 642 F. Supp. 8, 9-10 (D. Utah 1983). The former case sent a certified question to the Kansas Supreme Court, on which the Tenth Circuit relied to reach its decision in *Burrus*. *See supra* note 76-77 and accompanying text. While the federal district court in *Homestead* recognized that the state sales taxes in that case could attach to the homestead, it also recognized an enforceability element to establishing that a state tax lien is choate. *Homestead*, 1993 WL 360389, at *3. In keeping with this principle, the district court sent another certified question to the Kansas Supreme Court to deter-

States Supreme Court decisions implying that the additional enforceability requirement exists.[83]

The Sixth Circuit also found enforceability to be a prerequisite to choateness.[84] The Sixth Circuit's decision rested on a parallel Supreme Court case,[85] and the Supreme Court's statement that "the choateness rule should be similar to the rule of priorities established for cases where an insolvent debtor is subject to a tax lien."[86]

The decisions of the Third and Sixth Circuits undermine the Tenth Circuit's holding.[87] While the interpretation of enforceability remains unclear, the Supreme Court's statements imply that enforceability should be a requirement in determining if the state lien is choate. The Tenth Circuit's abrupt departure from this interpretation suggests that other courts of appeals are unlikely to follow.

III. ACCUMULATED FUNDING DEFICIENCIES

A. *Background*

The Code requires that an employer who maintains a qualified employee benefit plan must meet minimum funding standards.[88] The employer can meet these standards by ensuring that the qualified plan has accumulated no funding deficiencies.[89] Failure to meet the minimum funding requirements results in

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mine whether the homestead exemption prevented the creditor from foreclosing on its sales tax lien. *Id.* at *4. In Jones v. St. Francis Hosp. & Sch. of Nursing, Inc., 594 P.2d 162, 166-67 (Kan. 1979), the court found that taxes were excepted from the homestead exemption, and that a forced sale could begin against a homestead to satisfy a tax lien. *Id.*; *see In re* Johnson, 872 P.2d 308, 310-11 (Kan. 1994). Therefore, in *Homestead*, the sales tax lien would have been entitled to priority because it was enforceable. With further analysis of the confusing events in *Homestead* and the related Kansas Supreme Court cases, the Tenth Circuit may have become aware of the detailed analysis those courts engaged in and, as a result, the Tenth Circuit may have been persuaded to rule otherwise. Essentially, in ruling against the enforceability element, the Tenth Circuit relied in part on a Kansas case which addressed an issue solely for the benefit of a federal district court which found that the enforceability element existed.

83. *Monica Fuel, Inc.*, 56 F.3d at 512 n.13 (citing *McDermott*, 507 U.S. at 452 n.5 (acknowledging that the lien therein "was perfected . . . in the sense that it was definite as to the property in question, noncontingent, and summarily enforceable")); United States v. Vermont, 377 U.S. 351, 359 n.12 (1964) (acknowledging that the "municipal liens accorded priority in *New Britain* were also characterized as summarily enforceable").

84. "[T]he state lien holder must show that he had the right to enforce the lien at some time prior to the attachment of the federal lien." *Terwilliger's*, 911 F.2d at 1176. Note that this decision barely preceded that of the Tenth Circuit's; therefore, the court may not have had the benefit of reviewing the Sixth Circuit's opinion.

85. *Id.* A state lien holder must be able to enforce the lien prior to attachment of the federal lien. *Id.* Otherwise, "[n]umerous contingencies might arise that would prevent the attachment lien from ever becoming perfected by a judgment awarded and recorded." *Id.* (quoting United States v. Security Trust & Sav. Bank, 340 U.S. 47, 50 (1950)).

86. *Id.*; *see supra* note 50.

87. Another federal court of appeals addressed this issue and it is reasonable to infer that it recognizes an enforceability element. *See In re* Thriftway Auto Rental Corp. v. Herzog, 457 F.2d 409, 414 n.8 (2d Cir. 1971).

88. I.R.C. § 412(a) (1994).

89. *Id.* In general terms, the accumulated funding deficiency is the amount by which the charges to the standard funding account exceed the credits to such an account. *See id.*

the assessment of a tax equal to ten percent of the deficiency at the end of any plan year.[90] Most employers who fail to maintain the minimum funding standards do so as a consequence of financial hardship.[91] This was the case in In re *CF&I Fabricators*,[92] where the employer failed to meet the minimum funding standards before petitioning for Chapter 11 reorganization.[93]

Pursuant to the Bankruptcy Code, excise taxes accruing before bankruptcy or penalties to compensate for pecuniary losses merit priority payment.[94] While the provisions allowing the tax on accumulated funding deficiencies come under the Internal Revenue Code section "Miscellaneous Excise Taxes," that label is not necessarily determinative of the tax's priority in bankruptcy.[95] The tax may, in fact, be more adequately described as a penalty. The tax should be analyzed under a four-part test adopted by the Ninth Circuit in In re *Lorber Industries*[96] to determine if it is an excise tax or a penalty.[97] The four factors include whether the "tax" is imposed: (1) as an involuntary monetary burden; (2) pursuant to statutory law; (3) for public purposes; and (4) under the police or taxing power.[98]

B. *In re* CF&I Fabricators[99]

1. Facts

The debtors filed petitions for bankruptcy under Chapter 11 to reorganize because of their inability to fund two pension plans.[100] The IRS then filed notice of claims for taxes imposed pursuant to § 4971 and alleged that the taxes, almost $42 million, merited priority status under § 507 of the Bankruptcy Code.[101] The debtors argued that these taxes were penalties and

90. I.R.C. § 4971(a) (1994). Additional taxes equal to the amount of the deficiency are imposed if the deficiency is not promptly corrected. I.R.C. § 4971(b).

91. *In re* CF&I Fabricators, 53 F.3d 1155 (10th Cir.), *cert. granted*, 116 S. Ct. 558 (1995).

92. *CF&I*, 53 F.3d at 1156.

93. *Id.* Chapter 11 of the Bankruptcy Code allows a debtor to file for bankruptcy without surrendering all non-exempt assets to creditors. 4 DANIEL R. COWANS, BANKRUPTCY LAW AND PRACTICE § 20.1, at 3 (6th ed. 1994). Under the automatic stay the debtor receives temporary relief from creditors while the debtor develops a plan for reorganization and repayment of creditors. *Id.*

94. 11 U.S.C. § 507(a)(8)(E), (G) (1994). *CF&I* determined that the priority status afforded these taxes was located at § 507(a)(7)(E), (G). *CF&I*, 53 F.3d at 1156. This Survey will refer to the amended provisions as the texts are virtually identical.

95. "Congress' labeling of [an] exaction as a tax is not determinative of its status for priority in bankruptcy." *CF&I*, 53 F.3d at 1157 (quoting *In re* Cassidy, 983 F.2d 161, 163 (10th Cir. 1992)).

96. 675 F.2d 1062 (9th Cir. 1982).

97. *Lorber*, 675 F.2d at 1066.

98. *Id.* Failing any part of this test leads to a conclusion that the assessment was a penalty rather than a tax. *See infra* note 109 and accompanying text.

99. 53 F.3d 1155 (10th Cir.), *cert. granted*, 116 S. Ct. 558 (1995).

100. *In re* CF&I Fabricators, 148 B.R. 332, 334 (Bankr. D. Utah 1992), *cert. granted*, 116 S. Ct. 558 (1995).

101. *Id.* at 335, 337.

should have been disallowed.[102] The bankruptcy court agreed with the debtors and refused to grant the liens priority status.[103]

2. Decision

The Tenth Circuit affirmed the bankruptcy court's findings and its analysis of the § 4971 tax under the four-part *Lorber* test.[104] The court reinforced the doctrine that the label Congress places on an exaction is not determinative of its status as a tax or penalty.[105] Neither the bankruptcy court nor the Tenth Circuit presented a detailed analysis of the *Lorber* test. Therefore, the application of the facts in this case to that test is provided below.

3. Analysis

The imposition of the tax in *CF&I* resulted from an obligation to which the debtors did not consent; therefore, it meets the first part of the *Lorber* test because it was an involuntary monetary burden.[106] The tax also fulfills the second part of the *Lorber* test because it was imposed pursuant to the Internal Revenue Code. With regard to the third part of the test, however, the tax serves no benefit, such as defraying governmental expenses, to the public.[107] The tax merely serves to insure the adequacy of funding certain employee benefit plans. The bankruptcy court noted that affording the § 4971 tax priority would result in additional harm to the individuals that the tax was designed to protect.[108] Finding that the § 4971 tax could not meet the requirements of the *Lorber* test, the Tenth Circuit concluded that the tax was neither a penalty nor entitled to priority status.[109]

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102. *Id.* Additionally, the debtors came to an agreement with the Pension Benefit Guaranty Corporation (PBGC) to terminate one plan, after which the PBGC would act as successor trustee of the plan and become liable for benefits to plan participants. *Id.* at 336. The debtors objected to many of the taxes, claiming that the plan of reorganization or direction of the bankruptcy court prevented the payment of funds to the plan. *Id.* Therefore, the debtors claimed that it was inequitable for the IRS to continue assessing taxes for the accumulated funding deficiency. *Id.* The bankruptcy court, as well as the Tenth Circuit, addressed additional claims of equitable subordination in this case. *Id.*; *CF&I*, 53 F.3d at 1158. Although beyond the scope of this Survey, the issue of equitable subordination is perhaps the most important issue in this case and was the reason a petition for certiorari has been granted. *Id.* The Tenth Circuit held that a nonpecuniary loss tax penalty claim could be equitably subordinated to the claims of general unsecured creditors. *Id.* at 1159. The Sixth Circuit reached a similar conclusion in light of Congress's express intention to provide priority to tax penalties. *In re* First Truck Lines, Inc., 48 F.3d 210, 212 (6th Cir.), *cert. granted*, 116 S. Ct. 558 (1995). Both circuits held that it was reasonable to allow the bankruptcy court to exercise its discretion in order to ensure fair treatment and an equitable result. *Id.* at 218; *CF&I*, 53 F.3d at 1159.

103. In re *CF&I Fabricators*, 148 B.R. at 343.

104. *CF&I*, 53 F.3d at 1158.

105. *See supra* note 95.

106. *See In re* Farmers Frozen Food Co., 221 F. Supp. 385, 387 (N.D. Cal. 1963).

107. *Lorber*, 675 F.2d at 1066.

108. *CF&I*, 148 B.R. at 339. Affording the IRS's claims priority would be at the expense of unsecured pre-petition creditors which include the members of the pension plans themselves. *Id.* The IRS acknowledged that if the court accepted the *Lorber* analysis, this third prong of the test could not be met. *Id.* at 338. With regard to the last part of the *Lorber* test, the § 4971 tax was clearly imposed pursuant to the federal government's taxing or police powers.

109. *CF&I*, 53 F.3d at 1158. The legislative history of § 4971 further substantiates this hold-

4. Other Circuits

The Sixth Circuit was the only other circuit court to treat the issue presented in *CF&I*.[110] The Sixth Circuit relied on Congress's label of § 4971 as an excise tax as dispositive[111] and refused to consider the *Lorber* test.[112] It rejected the holding that labels are not determinative as to whether a lien is a tax or a penalty and concluded that federal courts do not have unlimited license to challenge Congress's designation of certain taxes.[113]

The Fourth and Fifth Circuits interpreted the priority status afforded § 4941 exactions, albeit in reference to a different code section.[114] They considered whether, for bankruptcy purposes, a court may look beyond Congress's characterization of an exaction. Both circuits held that the characterization of § 4941 exactions as a tax would contradict the very notion of fairness and public policy against punishing innocent creditors.[115]

At least one commentator has stated that it was unfortunate that the Supreme Court did not resolve the circuit split.[116] In light of recent Supreme Court decisions favoring the plain meaning rule,[117] many courts confronting this issue will likely side with the Sixth Circuit's decision. In light of Tenth Circuit precedent, however, *CF&I* was correctly decided and should remain the law until the Supreme Court confronts this issue.

IV. PERFECTION OF FEDERAL TAX LIENS

A. *Background*

When a taxpayer fails to pay assessed taxes, the tax due becomes a lien "upon all property and rights to property" belonging to the taxpayer.[118] Generally, the lien is not perfected and enforceable against third parties until notice has been properly filed pursuant to state law.[119] The Bankruptcy Code

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ing: "The [Employee Retirement Income Security Act] provides new and more effective penalties where employers fail to meet funding standards . . . . [T]he bill places the obligation for funding and the *penalty* for underfunding on the person to whom it belongs—namely, the employer." H.R. REP. NO. 93-807, 93d Cong, 2d Sess. 25 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4694 (emphasis added).

110. *In re* Mansfield Tire & Rubber Co., 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 502 U.S. 1092 (1992).

111. *Mansfield Tire*, 942 F.2d at 1062.

112. *Id.* at 1057. The bankruptcy court in that case applied the four-part test and found that the § 4971 exaction failed the third prong of the test. *In re* Mansfield Tire & Rubber Co., 80 B.R. 395, 398 (Bankr. N.D. Ohio 1987).

113. *Mansfield Tire*, 942 F.2d at 1059-60.

114. *See In re* Kline, 547 F.2d 823 (4th Cir. 1977) (adopting the reasoning of the district court); *In re* Unified Control Sys., 586 F.2d 1036 (5th Cir. 1978). Section 4941 imposes a "tax" for self-dealing between a taxpayer and an exempt foundation. *See* David L. Kwass, Note, *Excise Taxes in Bankruptcy:* United States v. Mansfield Tire & Rubber Co. *Holds Congress to Its Word*, 12 VA. TAX REV. 513, 522 (1993).

115. *Kline*, 586 F.2d at 1038; *Unified Control Sys.*, 586 F.2d at 1037-38.

116. Kwass, *supra* note 114, at 523.

117. *See* United States v. Ron Pair Enter., 489 U.S. 235 (1989).

118. I.R.C. § 6321 (1994).

119. I.R.C. § 6323(a), (f) (1994). Subsection (f) provides that state law determines the proper place for filing, although the subsection does provide some default rules. I.R.C. § 6323(f). Every

provides that a trustee may avoid any unperfected statutory lien against a "bona fide purchaser . . . whether or not such purchaser exists."[120] Federal law looks to the law of the applicable state to determine the rights of a bona fide purchaser.[121]

The Uniform Commercial Code (U.C.C.) grants priority to claims of lien creditors over the claims of unperfected secured creditors.[122] The U.C.C. also states that a filing of notice continues to be effective against the attached collateral even upon transfer of the property.[123]

B. *In re* LMS Holding Co.[124]

1. Facts

On January 25, 1988, the IRS perfected its lien against property held by MAKO, Inc., a corporation which subsequently filed for bankruptcy under Chapter 11.[125] Retail Marketing Corp. (RMC) acquired the property, subject to a tax lien, pursuant to the corporation's reorganization plan.[126] After the transfer occurred, the IRS, with full knowledge of the transaction, chose not to file notice of the tax lien against RMC.[127] RMC then filed for bankruptcy under Chapter 11.[128] The bankruptcy court held that the IRS's failure to file notice of the lien against RMC entitled the trustee to avoid the lien.[129] As a

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state within the Tenth Circuit, with the exception of Utah, has enacted the Uniform Federal Lien Registration Act, which provides that notices of liens on real property are filed in the office of the county clerk where the property is located, while liens on personal property are generally to be filed with the state's secretary of state (where the taxpayer is a corporation). *See* COLO. REV. STAT. § 38-25-102(1)(b), (2)(a) (Supp. 1995); KAN. STAT. ANN. § 79-2614(b), (c)(1) (1989); N.M. STAT. ANN. § 48-1-1(A), (B) (Michie 1995) (liens on personal property are filed in the county where the taxpayer resides); OKLA. STAT. tit. 68, § 3403(B), (C)(1) (1992) (liens on personal property are filed in Oklahoma County); WYO. STAT. § 29-6-204(b), (c)(i) (Supp. 1995). Utah provides that all federal liens are to be filed in the county in which the property subject to the lien is located. UTAH CODE ANN. § 38-6-1 (1994).

Generally, such notice must at least provide the identity of the taxpayer, the tax liability under which the lien arose, and the date of the assessment. Treas. Reg. § 301.6323(f)-1(d)(2) (as amended in 1994). Federal tax liens need not describe the property attached since the obligation becomes a lien on all property of the taxpayer. *In re* LMS Holding Co., 50 F.3d 1526, 1530 (10th Cir. 1995).

120. 11 U.S.C. § 545(2) (1994).

121. *See e.g.*, *In re* McClaim, 447 F.2d 241, 243-44 (10th Cir. 1971), *cert. denied*, 405 U.S. 918 (1972) (holding that the priority of the trustee is determined pursuant to the law of the state in which the property is located).

122. U.C.C. § 9-301(1)(b), (3) (1995) (providing that generally "an unperfected security interest is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected").

123. U.C.C. § 9-402(7) (1995). The official comments state that no new filing is necessary in this case. *Id.* official cmt. 8. "[A]ny person searching the condition of ownership of a debtor must make inquiry as to the debtor's source of title, and must search in the name of a former owner if circumstances seem to require it." *Id.*

124. 50 F.3d 1526 (10th Cir. 1995).

125. United States v. LMS Holding Co., 161 B.R. 1020, 1021 (N.D. Okla. 1993), *rev'd*, 50 F.3d 1526 (10th Cir. 1995).

126. *Id.* RMC also agreed to assume all liabilities of MAKO. *LMS Holding*, 50 F.3d at 1526.

127. *LMS Holding*, 161 B.R. at 1021.

128. *Id.*

129. *Id.*

result, the IRS held an unsecured claim.[130] The district court affirmed, holding that the IRS had knowledge of the transfer of assets and was required to file notice of the lien in the name of RMC.[131]

2. Decision

The Tenth Circuit acknowledged that where the identity of a debtor has truly changed, no new filing is necessary.[132] The transfer to RMC was not merely a change in the debtor's identity, but rather a change to an unrelated third party.[133] Furthermore, the Tenth Circuit noted that RMC's assumption of MAKO's tax liability did not justify characterizing RMC as the taxpayer in this matter.[134] The Tenth Circuit's decision hinged on its interpretation of U.C.C. § 9-402(7), which provides that the security interest in collateral continues to be effective even after the collateral is transferred to another party.[135] As a result, the IRS's lien continued to be effective against the property purchased by RMC. The Tenth Circuit reversed the findings of the bankruptcy and district courts.[136] The court also stated that the IRS was not entitled to enforce its lien against property RMC acquired independently of the transaction with MAKO.[137]

3. Analysis

The Tenth Circuit correctly decided that this was not a case of a debtor name change but rather a complete transfer of assets to another entity. While the U.C.C. states that a prior lien remains effective against the transferred property, it makes no reference to extending that lien to additional property of the acquiring party. It would not be surprising if this case came about as the result of an IRS error in filing a financing statement and the agency's woeful attempt to correct an inexcusable mistake.

V. Federal Estate and Gift Tax Disclaimers

A. *Background*

Taxes are based on the value of a decedent's estate.[138] In arriving at the net taxable value of a decedent's estate, the value of all property transferred to a surviving spouse is deducted from the gross estate.[139] Testamentary transfers, such as a bequest pursuant to the decedent's will, may be disclaimed by

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130. *Id.*
131. *Id.* at 1023.
132. *LMS Holding*, 50 F.3d at 1528. The IRS relied on two cases where federal courts held that a new filing was not necessary in the case of a name change of the debtor. *Id.* (citing Davis v. United States, 705 F. Supp. 446 (C.D. Ill. 1989); United States v. Clark, 81-1 T.C.M. (CCH) 9406 (S.D. Fla. 1981)).
133. *Id.* at 1528-29.
134. *Id.* RMC simply remains the transferee in this situation, not the taxpayer. *Id.*
135. For a further discussion of § 9-402(7), see *supra* note 123 and accompanying text.
136. *LMS Holding*, 50 F.3d at 1530.
137. *Id.*
138. I.R.C. § 2001 (1994).
139. I.R.C. § 2056(a) (1994).

the recipient and such property will transfer pursuant to state law.[140] If a recipient of a testamentary transfer disclaims such interest and the property transfers pursuant to state law to the surviving spouse, the estate is entitled to deduct the transfer in arriving at the net taxable estate.[141]

A disclaimer is valid if it meets four requirements. The disclaimer must: (1) be in writing; (2) be received by the transferor or his personal representative within certain time constraints; (3) be made by a person who receives no interests or benefits of the property; and (4) pass such interest *without direction* on the part of the person making the disclaimer.[142]

In the Tenth Circuit, a disclaimed interest passes as though the person making the disclaimer predeceased the decedent.[143] The states generally mandate that when the devisee or legatee is related to the testator and is treated as if having predeceased the testator, all issue of the devisee or legatee take in place of that individual.[144]

B. DePaoli v. Commissioner[145]

1. Facts

Quinto DePaoli, Sr. died, leaving his entire estate to his son Quinto DePaoli, Jr.[146] The son and Soila, Quinto Sr.'s wife, sought to have the probated will set aside so that the property would instead transfer to the mother.[147] The son agreed to accept $600,000 from the estate in return for his decision not to contest the will.[148] The federal tax return for the estate indicated

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140. *See* Estate of Bennett v. Commissioner, 100 T.C. 42, 67 (1993). For code provisions discussing disclaimer, see I.R.C. §§ 2046, 2518 (1994).

141. Treas. Reg. § 20.2056(d)-1(b) (as amended in 1986) (qualifying the transfer for the surviving spouse deduction).

142. I.R.C. § 2518(b) (emphasis added). If the formal requirements of § 2518 are met, the transferred property is treated not as if the property passed from the transferor to the disclaimant then to the ultimate taker, but instead as if the property passed directly from the transferor to the ultimate taker. Grayson M.P. McCouch, *Timely Disclaimers and Taxable Transfers*, 47 U. MIAMI L. REV. 1043, 1057 (1993). As a result, only one gift or estate tax is imposed rather than two separate taxes on two transfers. *Id.* The resulting transfer closely resembles a power of appointment, the major difference being § 2518's formal requirements. *Id.* The two methods of transfer, however, reach strikingly different results. While the use of a disclaimer results in no additional tax, a power of appointment often results in additional taxes. *Id.* at 1057-58; *see also* I.R.C. §§ 2038, 2041 (1994). Some commentators have suggested that disclaimers should be treated as taxable transfers to achieve a more consistent outcome, simplify taxation, and end the problems associated with determining if disclaimers meet the requirements of § 2518. Joan B. Ellsworth, *On Disclaimers: Let's Renounce I.R.C. Section 2518*, 38 VILL. L. REV. 693, 775 (1993).

143. COLO. REV. STAT. § 15-11-801(4)(a) (Supp. 1995); KAN. STAT. ANN. § 59-2293(a) (1994); N.M. STAT. ANN. § 45-2-801(D) (Michie 1995); OKLA. STAT. tit. 84, § 26 (1990); UTAH CODE ANN. § 75-2-801(3) (1993); WYO. STAT. § 2-1-404(a)(ii) (1980 & Supp. 1995). Wyoming is the only state providing that the interest will pass as if the disclaimant predeceased the decedent only if the disclaimant is a residuary beneficiary. WYO. STAT. § 2-1-404 (a)(ii).

144. *See* COLO. REV. STAT. § 15-11-603(2)(a) (1995); KAN. STAT. ANN. § 59-615(a) (1994); N.M. STAT. ANN. § 45-2-603 (Michie 1995); OKLA. STAT. tit. 84, § 142 (1990); UTAH CODE ANN. § 75-2-605 (1993); WYO. STAT. § 2-6-106 (1980).

145. 62 F.3d 1259 (10th Cir. 1995).

146. *Depaoli*, 62 F.3d at 1260.

147. *Id.*

148. *Id.* The $600,000 represents the maximum amount Quinto Sr. could have transferred to

that the entire estate, less the $600,000 transferred to the son, passed to Soila and thus qualified for the surviving spouse deduction.[149] He alleged that he made a qualified disclaimer in which he directed that the property disclaimed be transferred to Soila.[150] The Commissioner denied the marital deduction arguing: (1) that the probated will bequeathed everything to the son; (2) that the disclaimer was invalid due to the son's direction of the property to his mother; and (3) that as a result of the invalid disclaimer, he was liable for gift tax on the property transferred to his mother.[151] Quinto Sr.'s personal representative and the son alleged that the disclaimer was valid because the property would have passed to Soila in accordance with state law even without the son's direction.[152] The Tax Court agreed with the IRS and held the disclaimer invalid.[153]

2. Decision

The Tenth Circuit focused on whether the son's interest would have passed, under state law, to Soila or his issue. The son had two illegitimate children.[154] Under New Mexico law, an illegitimate child is considered the issue of the father if the father has signed a writing that the child is the father's heir.[155] The Tax Court concluded that since the son included his two illegitimate children as dependents on his tax return, this writing was sufficient to meet the statutory requirements.[156] Thus, his interest would have passed to his sons, rather than Soila, without his direction.[157] The Tenth Circuit, however, concluded that the Code's definition of "son" is broader than that of the New Mexico probate code.[158] The court held that the tax returns were not signed with the intent of recognizing the illegitimate children as his issue.[159] Under this interpretation, the disclaimed interest would have passed to Soila pursuant to New Mexico law even without the son's direction, since the illegitimate sons did not qualify as his issue.[160] Thus, the disclaimer was valid under § 2518(b) of the Code.[161]

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his son without his estate incurring any tax liability. I.R.C. § 6018 (1994). As a result, the taxpayer claimed the entire estate would not be subject to tax since all $600,000 qualified for the marital deduction and the remaining $600,000 was exempt from tax.

149. *DePaoli*, 62 F.3d at 1260. The return failed to indicate that the property transferred to Soila as a result of a qualified disclaimer. *Id.*

150. *Id.* at 1260, 1266.

151. *Id.* at 1260-61.

152. *Id.* at 1261.

153. *Id.*

154. *Id.* at 1262.

155. N.M. STAT. ANN. § 45-2-109(B)(2) (Michie 1995).

156. *DePaoli*, 62 F.3d at 1263.

157. *Id.*

158. *Id.*

159. *Id.* at 1264.

160. *Id.* at 1265.

161. *Id.* at 1265. The Tenth Circuit acknowledged that the only issue involving I.R.C. § 2518(b) before them was whether the disclaimer was invalid due to the son's direction of the property to Soila. *Id.* at 1266.

3. Analysis

The Tenth Circuit's decision reflects the importance of examining state intestacy and property laws when considering the federal estate tax. Congress, by enacting the marital deduction, evidenced its intent that transfers of property as a result of death should not be subject to tax. While the disclaimer in this case was invalid, the ultimate transfer of property in *DePaoli* was of the nature of those specifically deemed exempt from tax by Congress.

VI. THE GIFT TAX: SAFE HARBOR RATES DO NOT APPLY TO BELOW-MARKET LOANS

A. *Background*

A federal gift tax is imposed on the transfer of any property by gift.[162] The gift tax affects more than purely gratuitous transfers. For example, it can apply to a sale or exchange of property where the fair market value of the property transferred exceeds the value of the consideration given in exchange.[163] It follows that when a taxpayer gives property in exchange for a promissory note, gift taxes may be imposed to the extent that the fair market value of the property transferred exceeds the fair market value of the note received in exchange. In assessing the fair market value of a promissory note, the IRS considers the face value of the note, the stated interest rate, the appropriate market rate of interest, and the term of the note.[164]

Under I.R.C. § 483, the holder of an installment contract which contains "total unstated interest" may be forced to recognize payments representing principal under contract terms as interest for income tax purposes.[165] Section 483 serves to prevent the avoidance of income taxes, whereby payments received under an installment contract are payments of principal which may be taxed as a capital gain rather than payments of interest taxed as ordinary income.[166] Under this provision, the interest rate applied by the government in assessing fair market value of the installment contract is a published rate regularly determined by the Secretary of the Treasury.[167] If the sum of the payments of principal received under the installment contract terms exceeds the present value of such principal payments and interest discounted at the rate determined by the Secretary, the contract contains unstated interest.[168]

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162. I.R.C. § 2501(a)(1) (1994).

163. I.R.C. § 2512(b) (1994); Commissioner v. Wemyss, 324 U.S. 303, 306 (1945); *see also* Treas. Reg. § 25.2512-8 (as amended in 1992) (excluding transactions made in the ordinary course of business from this provision).

164. Blackburn v. Commissioner, 20 T.C. 204, 207 (1953).

165. I.R.C. § 483(a) (1994).

166. Schusterman v. United States, 63 F.3d 986, 990 (10th Cir. 1995). For a complete discussion of *Schusterman*, see *infra* notes 177-86 and accompanying text.

167. I.R.C. § 483(b) (1994); I.R.C. § 1274(d) (1994). The version of § 483 in place at the time the Schusterman trusts were created provided that the interest rates were determined by the Secretary. *See Schusterman*, 63 F.3d at 989. The amended version simply refers one to § 1274 for determination of the applicable rate rather than to the regulations. I.R.C. § 483(b).

168. I.R.C. § 483(b).

Portions of payments received must be recharacterized: from payments of principal to payments of interest.[169] If the terms of the installment contract provide for an interest rate equal to or greater than the rate determined by the Secretary, no recharacterization would be necessary.[170]

In *Schusterman*, the Tenth Circuit decided whether § 483 applied to the gift tax provisions of the Code. The two circuits that had previously addressed this issue had reached conflicting conclusions. In *Ballard v. Commissioner*,[171] the taxpayer argued that the provisions of § 483 applied to all provisions of the Internal Revenue Code.[172] Thus, a taxpayer complying with the safe harbor rate provisions should not suffer a penalty by the imposition of gift taxes where the safe harbor rate falls below the prevailing market rate of interest.[173] The Seventh Circuit in *Ballard* ruled in favor of the taxpayer.[174] The Eight Circuit Court of Appeals ruled otherwise when presented with a similar argument.[175] Agreeing that § 483 applied to the entire Internal Revenue Code, the Eight Circuit concurred with the tax court's determination that "nothing in the language of § 483 . . . indicates that this section has anything to do with valuation."[176]

B. Schusterman v. United States[177]

1. Facts

The taxpayers, Charles and Lynn Schusterman, transferred stock to five irrevocable trusts in exchange for promissory notes in the principal amount of the fair market value of the stock, $7,954,046.[178] The notes provided for interest at a rate of six percent, which is the safe harbor rate as provided by § 483 and the appropriate treasury regulation.[179] The prevailing market interest rate at that time was eleven and one-half percent.[180] Counsel advised the taxpayers to set the interest rates of the promissory notes equal to the safe harbor rate provided by § 483 to avoid the imposition of any gift taxes by the IRS.[181] The IRS informed them that § 483 did not preclude the assessment

169. *Id.*

170. "In sum, I.R.C. § 483 prevents a seller of property under an installment contract for sale or exchange of property from converting ordinary income (interest) into capital gains (principal)." *Schusterman*, 63 F.3d at 990. The court continued: "The interest rate set by regulation is known as the 'safe harbor' rate because a contract for the sale or exchange of property that employs the interest rate will by definition never contain 'total unstated interest.'" *Id.*

171. 854 F.2d 185 (7th Cir. 1988).

172. *Ballard*, 854 F.2d at 187. Mrs. Ballard must have been relying on the prefatory language of § 483 which states, "For purposes of this *title* . . . [this provision applies to] the sale or exchange of any property." I.R.C. § 483(a)(1) (emphasis added). The word "title" refers to Title 26 of the United States Code, more commonly known as the Internal Revenue Code. *Id.*

173. *Ballard*, 854 F.2d at 187.

174. *Id.* at 189.

175. Krabbenhoft v. Commissioner, 939 F.2d 529, 532 (8th Cir.), *cert. denied*, 502 U.S. 1072 (1991).

176. *Id.* (quoting Krabbenhoft v. Commissioner, 94 T.C. 887, 890 (1990)).

177. 63 F.3d 986 (10th Cir. 1995).

178. *Schusterman*, 63 F.3d at 988.

179. *Id.*

180. *Id.*

181. *Id.*

of gift taxes in this situation and taxed the difference between the value of the stock transferred and the present value of the notes, discounted at the prevailing eleven and one-half percent market interest rate.[182] The taxpayers paid the gift taxes and then sued for a refund.[183] The district court agreed with the findings of the Eight Circuit in *Krabbenhoft* and held in favor of the IRS.[184]

2. Decision

Like the federal district court, the Tenth Circuit sided with the Eight Circuit's holding in *Krabbenhoft*. While recognizing that § 483 applies to all provisions of the Code, the Tenth Circuit agreed that it is irrelevant for purposes of gift tax valuation.[185] The court stated that while the safe harbor rate protects taxpayers from recharacterization of income under § 483, there were no indications that "the safe harbor rate insulates a taxpayer from the adverse gift tax effects of § 2512."[186]

3. Analysis

An examination of the purpose of § 483 leads to the conclusion that the Tenth Circuit reached the correct decision. Section 483 serves only to insure that payments received under an installment sale or promissory note are correctly characterized, and is solely concerned with the income tax consequences of such a transaction. Had the promissory notes in *Schusterman* provided for interest at five percent, § 483 would take effect, recharacterizing payments of principal to payments of interest but would have no bearing on valuation. Since the stated interest rate of the promissory notes met the safe harbor rate, § 483 would have no income tax consequences.

CONCLUSION

The Tenth Circuit continues to apply established tests in reaching well-reasoned conclusions to issues involving federal taxation. Generally, the court appears to favor erring on the side of the taxpayer unless the law conclusively holds to the contrary. While this is an admirable approach to the tax laws, it seems lead to muddy analysis, as applied in *Burrus*, where the area of federal tax liens remains a thorn in the Tenth Circuit's side.

Steven M. Weiser

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182. *Id.* This resulted in gift taxes owed of $1,157,127.72. *Id.*
183. *Id.*
184. *Id.* at 988-89.
185. *Id.* at 993.
186. *Id.*