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TAXATION

JAMES SERVEN*

During 1991,[1] the Tenth Circuit Court of Appeals demonstrated that the Internal Revenue Code of 1986 ("the Code") is in fact a "mirror of life,"[2] as the court decided cases involving a wide array of personal and business experiences and transactions, ranging from oil drilling in Wyoming to drug running in Belize, and from timeshare units in Park City, Utah, to retail malls in Concordia, Kansas. Many of these were cases of first impression in the circuit, and one case[3] addressed an issue of first impression in the federal courts. The Tenth Circuit's approach to resolving these controversies is instructive to anyone with an interest in federal tax matters.

Some of the cases decided by the Tenth Circuit in 1991 resolved tax liabilities dating back to the late 1970's and very early 1980's, and involved the application of "old law." Aside from the obvious commentary these cases provide as to the speed with which the Internal Revenue Service ("the IRS") and our judicial system process tax controversies, the cases are a reminder that the Code has undergone a terrifying degree of revision in the interim.[4] The flood of tax legislation that characterized the 1980's prompted one commentator to describe the Tax Reform Act of 1986 as "the latest in a series of attacks of tax legislative diarrhea that seem to strike the American people, like swine flu or Taiwan Flu, about every sixteen to eighteen months."[5] Where appropriate,

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1. This Note examines cases decided by the Tenth Circuit Court of Appeals during 1991 in the area of federal income, estate and gift taxation.

2. *See* JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 1 (6th ed. 1987) ("There is no such thing as pure tax law. Instead, tax principles relate to events and transactions that would go on even if there were no federal income tax . . . .").

3. Schroeder v. United States, 924 F.2d 1547 (10th Cir. 1991).

4. In the 1980's, the Code has been amended by, *inter alia*, the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981); the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982); the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982); the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984); the Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426 (1984); the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); the Revenue Act of 1987 (Title X of the Omnibus Budget Reconciliation Act of 1987), Pub. L. No. 100-203, 101 Stat. 1330 (1987); the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988); the Revenue Reconciliation Act of 1989 (Title VII of the Omnibus Budget Reconciliation Act of 1989); Pub. L. No. 101-239, 103 Stat. 2106 (1989); and the Revenue Reconciliation Act of 1990 (Title XI of the Omnibus Budget Reconciliation Act of 1990), Pub. L. No. 101-508, 104 Stat. 1388 (1990). The year 1991 passed without the enactment of any major federal tax legislation.

5. Charles O. Galvin, *Tax Reform: What? Again? A Rose by any Other Name. . .*, *in* 39 MAJOR TAX PLANNING ¶ 1200, at 12-1 (1987).

this Note will point out where the relevant provisions of the Code may have been amended, and how the issue might be treated today.

I. Application of the Step Transaction Doctrine to Recast Purported Reorganization Into Parent-Subsidiary Liquidation: *Associated Wholesale Grocers, Inc. v. United States*[6]

A. *Background*

The gross income of a taxpayer includes all gains and losses derived from dealings in property.[7] Gain from the sale or other disposition of property is computed as the excess of the amount realized therefrom over the adjusted basis of the property, and loss is calculated as the excess of the adjusted basis over the amount realized.[8] As a general rule, the entire amount of gain or loss realized upon the sale or exchange of property must be recognized unless otherwise specifically provided in the Code.[9]

Corporate liquidations are not immune from this general rule, and the amount received[10] by a shareholder as a liquidating distribution from a corporation is treated as made in full payment in exchange for the shareholder's stock.[11] However, under an important exception to this rule, no gain or loss is recognized on the receipt by a parent corporation of property distributed in complete liquidation of a subsidiary corporation,[12] provided that certain requirements[13] are satisfied.[14] Upon receipt of the property distributed by the subsidiary, the parent will take a "carryover" basis in such property, that is, a basis which is the same as it was in the hands of the subsidiary.[15]

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6. 927 F.2d 1517 (10th Cir. 1991).
7. I.R.C. § 61(a)(3) (1988).
8. *Id.* § 1001(a).
9. *Id.* § 1001(c).
10. The amount received is generally measured by the amount of money and the fair market value of other property received in the liquidation. *Id.* § 1001(b).
11. *Id.* § 331.
12. *Id.* § 332(a).
13. The requirements of I.R.C. § 332(b) include: (1) the corporation receiving the property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock in such other corporation meeting the requirements of I.R.C. § 1504(a)(2) (that is, the ownership consists of at least 80% of the total voting power of the stock of the other corporation, and has a value equal to at least 80% of the total value of the stock of such other corporation); and either (2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year, or (3) the distribution is one of a series of distributions by the other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan.
14. The transactions at issue in *Associated Wholesale Grocers* occurred in 1980, under a slightly different version of I.R.C. § 332(b). The stated requirements were revised by the Tax Reform Act of 1986, but only to cross-reference the more specific rules of I.R.C. § 1504(a)(2) in the first of the three requirements noted above.
15. I.R.C. § 334(b) (1988). The carry-over basis rule applies only to the parent meeting the 80% stock ownership test described *supra* note 13. Although *Associated Wholesale*

Absent the provisions of I.R.C. § 332, gain or loss would be recognized by a parent corporation upon the liquidation of its subsidiary[16] as the difference between the fair market value of the assets received and the parent's basis in its stock of the subsidiary.[17] The fact that I.R.C. § 332 acts to disallow *losses* as well as to shield gains makes it a double-edged sword that can lead to harsh results. For example, assume parent PQR purchased all the outstanding stock of subsidiary STU five years ago for $500,000. STU's only asset was a parcel of vacant land worth $500,000, in which STU had a basis of $250,000. If the land, and therefore STU's stock, is today worth only $400,000, I.R.C. § 332 would deny recognition of PQR's $100,000 economic loss upon a complete liquidation of the subsidiary. Moreover, PQR would take a carryover basis of $250,000 in the land, and would recognize a *gain* of $250,000 if it then sold the land for its $400,000 fair market value, despite the fact that, overall, PQR has suffered a $100,000 economic loss over the course of the transaction.

On the other hand, if PQR simply sold its STU stock for $400,000, the $100,000 loss—measured by the difference between the sale proceeds and PQR's $500,000 basis in the STU stock—could be properly

Grocers related to a 1980 transaction, and thus was determined under provisions of I.R.C. § 334(b) in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, the amendments made to I.R.C. § 334(b) by those tax bills would not today affect Super Market Developers's calculation of its basis in the stock received from its subsidiary. This is particularly true because Associated Wholesale Grocers acquired the Weston Investment stock by tender offer in 1976, some four years prior to the transaction at issue. If the acquisition had occurred within two years of the adoption of a plan of liquidation, the taxpayers could have taken advantage of the prior version of I.R.C. § 332(b)(2), which codified the principle of Kimball-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951). That case provided that when a parent acquires a subsidiary and within two years adopts a plan of complete liquidation of the subsidiary, the parent's basis in the subsidiary's assets will be determined by reference to the parent's basis in the stock of the subsidiary, and will not be carried over from the subsidiary. The prior provisions of I.R.C. § 332(b)(2) were repealed by the Tax Equity and Fiscal Responsibility Act of 1982, and were replaced by the elective provisions of I.R.C. § 338. *See* Kansas Sand & Concrete, Inc. v. Commissioner, 462 F.2d 805 (10th Cir. 1972) (Where merger of subsidiary into parent fell under the literal terms of both the tax-free reorganization provisions of I.R.C. § 368(a)(1)(A) and the liquidation provisions that included prior I.R.C. § 334(b)(2), the latter took precedence and parent was required to use its basis in the subsidiary stock to determine its basis in assets received from the subsidiary, rather than use a carryover basis from the subsidiary.).

16. A related issue concerns the recognition of gain or loss by the *subsidiary* upon the distribution of its assets in complete liquidation. The transaction which was the subject of *Associated Wholesale Grocers* occurred prior to the repeal of prior I.R.C. § 337, which provided that no gain or loss was recognized by liquidating corporations that adopted so-called "12-month plans of liquidation." Today, I.R.C. § 336(a) requires a corporation to recognize gain or loss on the distribution of its property in complete liquidation, as if the property were sold to the distributee at its fair market value. However, Weston Investments would today be protected by the current version of I.R.C. § 337(a), which provides that no gain or loss is recognized by the liquidating corporation on the distribution with respect to property distributed to an 80% shareholder in a complete liquidation to which I.R.C. § 332 applies. Gain (but not loss) will be recognized on property distributed to minority shareholders. I.R.C. § 336(d)(3) (1988).

17. The loss disallowance rules of I.R.C. § 267 do not apply to corporate liquidations either in 1980 or today. *Id.* § 267(a)(1).

claimed.[18] For this reason, parent-subsidiary taxpayers occasionally find themselves in the position of desiring to avoid the operation of I.R.C. § 332 when a complete liquidation of the subsidiary would otherwise yield a loss.[19] This might occur, for example, if STU owned many parcels of land, and the goals of PQR were to terminate the corporate existence of STU, dispose of some of the STU assets and cause the remainder of the STU assets to be owned outright by PQR. Such was the dilemma of the taxpayers in *Associated Wholesale Grocers*.

B. *Facts*

In 1980, Associated Wholesale Grocers, Inc. ("Associated Wholesale Grocers") owned all the capital stock of Super Market Developers, Inc. ("Super Market Developers"), which in turn owned approximately 99.97% of the total outstanding shares of Weston Investment Co. ("Weston Investment"). Weston Investment was a publicly-traded holding company that owned a number of corporate supermarkets. During 1980, Associated Wholesale Grocers decided to discontinue allowing Super Market Developers to own and operate grocery stores through subsidiaries such as Weston Investment.

Super Market Developers could have caused Weston Investment to be liquidated, thus enabling all Weston Investment's grocery stores to be owned outright by Super Market Developers. Unfortunately, Super Market Developers had paid $11,727,716 for the Weston Investment stock, whereas Weston Investment's basis in its assets was apparently only $9,374,458 and the apparent fair market value of the Weston Investment assets was approximately $9,349,703.[20] If Super Market Developers was to wind up owning outright the grocery stores and other assets owned by Weston Investment, a complete liquidation of Weston Investment would have fallen within the rules of I.R.C. §§ 332 and 334, so that no loss would be recognized by Super Market Developers, and it would take a carry-over basis of $9,374,458 in Weston Investment's assets. The difference between the fair market value of Weston Investment's assets and the $11,727,716 that Super Market Developers had paid for the Weston Investment stock, otherwise recognizable as a loss in the absence of I.R.C. § 332, could not be claimed as such.

18. *Id.* § 1001.

19. The loss arises by virtue of I.R.C. §§ 331(a), 1001(a) and 1001(c).

20. The opinions of both the district court and the Tenth Circuit are somewhat confusing on this issue. The Tenth Circuit identified the $9,374,458 as "the carryover basis representing the market value of Weston's assets," Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1518 n.1 (10th Cir. 1991), but this statement is a *non sequitur*. In fact, the figure apparently represented Weston Investment's basis in its underlying assets. The district court states that Super Market Developers's basis in its Weston Investment stock was $11,727,716, and that the capital loss reported by the taxpayers was $2,353,258, Associated Wholesale Grocers, Inc. v. United States, 720 F. Supp. 887, 888 (D. Kan. 1989), a result that can only be obtained by comparison to the $9,374,458 figure. The latter figure is not mentioned at all in the district court's opinion, however, and it is not possible to reconcile these figures against the $9,349,703 paid by Elder, Inc. in the merger.

It so happened that Weston Investment itself owned various subsidiaries, one of which was Weston Market, Inc. ("Weston Market"). The grocery store owned by Weston Market was managed by Thomas Elder, who expressed an interest in buying Weston Market. Associated Wholesale Grocers, Super Market Developers and Weston Investment seized upon Elder's interest in acquiring Weston Market as an opportunity to recruit him in a transaction that would provide him with ownership of Weston Market, transfer ownership of all the grocery stores directly to Super Market Developers, and allow Associated Wholesale Grocers to claim a capital loss in excess of $2 million on its consolidated federal income tax return.

In December of 1980, a two-step transaction was consummated between Weston Investment, Super Market Developers and a newly-formed corporation wholly owned by Elder called Elder Food Mart, Inc. ("Elder, Inc."). In the first step, Weston Investment was merged into Elder, Inc., with Elder, Inc. as the surviving corporation. Rather than exchanging Elder, Inc. stock in the merger, however, Elder, Inc. exchanged $300,000 in cash and a non-interest bearing demand promissory note in the amount of $9,049,703 for the Weston Investment stock.[21] This consideration was distributed among the Weston Investment shareholders, with part of the cash earmarked to cash out Weston Investment's minority shareholders.

In the second step, under a so-called "Agreement and Plan of Reorganization" which took effect "immediately following the time of effectiveness of the merger,"[22] Super Market Developers bought back all the assets acquired by Elder, Inc. under the merger agreement *except* for the stock of Weston Market. In exchange for those assets, Super Market Developers paid an amount equal to the principal amount of the promissory note given by Elder, Inc. in the merger and now held by Super Market Developers, plus an amount equal to the cash received by the cashed-out minority shareholders.[23] The net effect was that the $9,049,703 represented by the promissory note simply became a "wash," and Elder, Inc. had essentially paid $300,000, less the amounts used to cash out Weston Investment's minority shareholders, to acquire all the stock of Weston Market. For its part, Super Market Developers was now the outright owner of all the grocery stores formerly owned by Weston Investment, which had been merged out of existence, and had essentially provided no consideration other than the cash used to cash out Weston Investment's minority shareholders. Consistent with the two-part nature of the transaction, Associated Wholesale Grocers and Super Market Developers treated the merger aspect of the transaction as

21. Although technically a merger under state law, the transaction was apparently reported as a taxable event by Associated Wholesale Grocers, presumably because the merger did not satisfy (and most likely was specifically structured *not* to satisfy) the judicially-created "continuity of interest" test required to be met for the merger to qualify as a tax-free reorganization under I.R.C. § 368(a)(1)(A).

22. *Associated Wholesale Grocers, Inc.*, 927 F.2d at 1518-19.

23. *Id.* at 1519.

giving rise to a reportable loss of $2,353,258,[24] and claimed that loss as a long-term capital loss in their consolidated federal income tax return for 1980.[25]

The merger-and-repurchase nature of the transaction as structured was clearly aimed at circumventing I.R.C. § 332 and creating a tax loss for Associated Wholesale Grocers and Super Market Developers on their consolidated return. Predictably relying upon the well-known "step transaction doctrine," the IRS denied Associated Wholesale Grocers's capital loss. Associated Wholesale Grocers sued in district court after its administrative claim for refund was denied. The district court granted summary judgment for the government,[26] and the Tenth Circuit affirmed.

C. *The Tenth Circuit's Opinion*

Associated Wholesale Grocers presented the Tenth Circuit[27] with an opportunity to consider the application of the step transaction doctrine to corporate restructurings designed to avoid unwanted results under the Code. Under the judicially-created step transaction doctrine, "a series of formally separate steps may be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused on a particular end result."[28] By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may based "on a realistic view of the entire transaction."[29]

From the time of *Gregory v. Helvering*,[30] courts have consistently strived to elevate substance over form in an attempt to weed out those transactions which are a "mere device which put on the form of a [desired corporate arrangement] as a disguise for concealing its real character."[31] The issue in *Associated Wholesale Grocers*, then, was whether the *form* of the transaction was to prevail for federal income tax purposes, or

24. Again, the figures noted by the district court and the Tenth Circuit are difficult to verify. *See supra* note 20.

25. The same end result could have been achieved by structuring the transaction as a liquidation of Weston Investment, followed by a sale by Super Market Developers to Elder of the stock of Weston Market now owned directly by Super Market Developers, for something less than $300,000. However, the liquidation transaction would not have given rise to gain or loss under I.R.C. § 332, and Super Market Developers would have taken a carryover basis from Weston Investment in the Weston Investment assets. Super Market Developers would have thus owned those assets with both a basis and a fair market value of approximately $9.3 million. The potential capital loss of over $2 million would have been lost forever.

26. Associated Wholesale Grocers, Inc. v. United States, 720 F. Supp. 887 (D. Kan. 1989).

27. The three-judge panel consisted of Judge Seymour, Judge Moore and Judge Brorby.

28. 1 BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.5, at 4-48 (1981).

29. *Id.* at 4-52.

30. 293 U.S. 465 (1935).

31. *Id.* at 469.

whether the *substance* of the transaction[32] was to be recognized and given effect. While recognizing that I.R.C. § 332 is not optional or elective, and that a number of planning possibilities are evident which may allow a corporation to avoid the application of that section,[33] the Tenth Circuit noted that such planning possibilities are not immunized from step transaction analysis.[34]

After a brief review of the major Supreme Court decisions dealing with the step transaction doctrine,[35] the Tenth Circuit noted that courts and commentators have identified three tests used in evaluating the step transaction doctrine: the "end result" test, the "interdependence" test, and the "binding commitment" test.[36] Noting that the first two tests are the most frequently applied,[37] the court proceeded to summarize each.

Under the "end result" test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[38] The "end result" test thus resembles the substance over form principle, under which "the end result of the series of interrelated steps controls the tax consequences of the whole."[39] The "interdependence" test, on the other hand, "focuses on the relationship between the steps, rather than on the 'end result.' "[40] This test examines "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relationships created by one transation would have been fruit-

32. The IRS claimed that the transaction constituted a parent-subsidiary liquidation of Weston Investment by Super Market Developers, followed by a sale of the Weston Market stock by Super Market Developers to Elder, Inc., with Super Market Developers continuing to own all the other assets formerly held by Weston Investment.

33. *See, e.g.*, 11 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 42.55, at 142 (1990). For example, the parent can dispose of sufficient stock to fail the 80% ownership test. Alternatively, the subsidiary might intentionally retain assets beyond the periods specified in I.R.C. §§ 332(b)(2) and (3). *Cf.* Rev. Rul. 77-150, 1977-1 C.B. 88.

34. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1525 (10th Cir. 1991). The taxpayer in *Associated Wholesale Grocers* had taken the position that the step transaction doctrine simply does not apply to transactions under I.R.C. § 332. However, the Tenth Circuit viewed the cases cited by the taxpayer as inapposite for this proposition.

35. Commissioner v. Clark, 489 U.S. 726, 738 (1989) (describing the step transaction doctrine to mean "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction"); Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by a devious path."); Gregory v. Helvering, 293 U.S. 465 (1935).

36. The "binding commitment" test was announced by the Supreme Court in Commissioner v. Gordon, 391 U.S. 83 (1968), but subsequent decisions have tended to limit *Gordon* to its facts. *Associated Wholesale Grocers*, 927 F.2d at 1522 n.6.

37. The Tenth Circuit did not necessarily state that the "end result" and the "interdependence" tests will be the *only* two tests that will be applied in the future, and it is possible that the Tenth Circuit might apply other formulations in appropriate circumstances.

38. *Associated Wholesale Grocers*, 927 F.2d at 1523 (quoting DAVID R. HERWITZ, BUSINESS PLANNING 804 (1966)).

39. Atchinson, Topeka & Santa Fe R.R. Co. v. United States, 443 F.2d 147, 151 (10th Cir. 1971)). The individual tax significance of each step in the transaction is irrelevant if the steps, when viewed as a whole, amount to a single taxable transaction. Crenshaw v. United States, 450 F.2d 472, 475 (5th Cir. 1971).

40. *Associated Wholesale Grocers*, 927 F.2d at 1523.

less without completion of the series."[41] The Tenth Circuit then went on to apply the "end result" and "interdependence" tests to the facts at hand. If the *Associated Wholesale Grocers* transaction could be shown to fall within the scope of either of the two tests, I.R.C. § 332 would apply and the capital loss claimed by the taxpayers would be disallowed.

The Tenth Circuit first concluded that the "end result" test had no application to I.R.C. § 332. On the authority of *Granite Trust Co. v. United States*,[42] the court concluded that I.R.C. § 332 is simply not an "end result" provision, but " 'rather one which prescribes specific conditions for the nonrecognition of realized gains or losses, conditions which, if not strictly met, make the section inapplicable.' "[43]

The Tenth Circuit then turned its attention to the "interdependence" test. In evaluating this test, the court considered whether "the steps were so interdependent that the legal relationships created by one transaction would have been fruitless without a completion of the series."[44] Following a review of the documents utilized in the two-step transaction,[45] the court had little trouble concluding that the various

41. Randolph E. Paul & Philip Zimet, *Step Transactions*, *in* SELECTED STUDIES IN FEDERAL TAXATION 200, 254 (2d Series 1938).

42. 238 F.2d 670 (1st Cir. 1956).

43. *Associated Wholesale Grocers*, 927 F.2d at 1524 (quoting *Granite Trust Co.*, 238 F.2d at 675). Given that I.R.C. § 332 provides a road map by which taxpayers can structure subsidiary liquidations to avoid gain or loss, finding the "end result" test to be inapplicable seems entirely correct. Otherwise, as the *Granite Trust* court had concluded, "taxpayers can, by taking appropriate steps, render [I.R.C. § 332] applicable or inapplicable as they choose, rather than be at the mercy of the Commissioner on an 'end-result' theory." *Granite Trust Co.*, 238 F.2d at 676. For example, if the "end result" test applied, a taxpayer attempting a parent-subsidiary liquidation who failed to follow the requirements of I.R.C. § 332 could nevertheless argue that the transaction should be treated as if it had satisfied these requirements because the "end result" of the liquidation otherwise fell within the scope of that section. Such an "end result" argument becomes, in effect, an "end run" argument, rendering the technical requirements of I.R.C. § 332 a nullity.

44. Paul & Zimet, *supra* note 41.

45. The termination clause in the merger agreement (the first step in the arrangement) expressly stated that the merger agreement terminated if the reorganization agreement (the second step) terminated prior to the merger's closing date. Thus, the two steps were contingent upon one another. The "merger agreement would bear no fruit unless the two-step series could be completed." *Associated Wholesale Grocers*, 927 F.2d at 1528. Moreover, the interconnection between the two transactions was sometimes explicitly acknowledged by the documents. For example, the reorganization agreement specifically provided that Super Market Developers was to purchase from Elder, Inc. the following:

> [A]ll of the assets of every kind and description acquired by [Elder, Inc.] pursuant to the Agreement of Merger, except for the shares of common stock of Weston. As part of the consideration [Super Market Developers] agrees to assume and discharge all of the obligations and liabilities of [Elder, Inc.] which were formerly the obligations and liabilities of [Weston Investment] and which became the obligations and liabilities of [Elder, Inc.] pursuant to the Agreement of Merger.

Id.

The effective date of the merger agreement was actually set forth in the reorganization agreement, and the closing of the transactions described in the reorganization agreement were to take place on the same day as the merger date, immediately following the time of effectiveness of the merger. In addition to buttressing the interdependence of the two steps, this provision placed the two steps as occurring at essentially the same point in time. This close timing of the steps was also relied upon by the Tenth Circuit in evaluating the step transaction doctrine, as it has by other courts and commentators.

Whether the Tenth Circuit would have found it more difficult to apply the "interdependence" test in the absence of these explicit provisions in the documents is uncertain,

steps of the arrangement were sufficiently interdependent so as to invoke the step transaction doctrine, with the result that the claimed capital loss was disallowed.

The taxpayer in *Associated Wholesale Grocers* contended that the step transaction doctrine simply has no application where a valid or legitimate business reason for structuring the transaction in a particular manner can be identified. Here, Associated Wholesale Grocers argued that the elimination of Weston Investment's minority shareholders provided a sufficient business purpose to override the application of the step transaction doctrine. After noting that the relationship between the step transaction doctrine and a purported "valid business purpose" doctrine was unclear, the Tenth Circuit "reject[ed] the contention that a valid business purpose bars application of step transaction analysis in this context,"[46] and ultimately dismissed the taxpayer's contention as merely make-weight.[47]

D. *Summary*

Application of the step transaction doctrine in *Associated Wholesale Grocers* was a matter of first impression for the Tenth Circuit. The case shows that the Tenth Circuit is willing to apply the step transaction doctrine with vigor in appropriate circumstances, and its recognition and application of the "end result" test and the "interdependence" test should be kept in mind by taxpayers and their advisors when structuring corporate reorganizations.

II. Substitute Return Prepared by Internal Revenue Service Not a "Filed Return" for Purposes of Dischargeability in Bankruptcy: *Bergstrom v. United States*[48]

A. *Background*

The Code permits the Secretary of the Treasury ("the Secretary") to prepare a federal income tax return for any person who fails to do so as required by law.[49] In the context of a liquidation proceeding under Chapter 7 of the Bankruptcy Code, an individual debtor may not receive a discharge from any debt for a tax with respect to which a return, if

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but provisions such as these certainly made the task easier. *Cf.* Bittker at ¶ 4.3.5. ("At one extreme, if the parties have agreed to take a series of steps, no one of which will be legally effective unless all are consummated, application of the step transaction doctrine is ordinarily assured.").

46. *Associated Wholesale Grocers*, 927 F.2d at 1527.

47. The Tenth Circuit shared "the government's skepticism as to the alleged significance of taxpayer's claimed business purpose." *Id.* Since the "taxpayer never made *any* inquiry . . . as to the willingness of the minority shareholders to sell their . . . shares . . . at any price . . . we reject the suggestion that taxpayer's 'purpose' in designing the merger and reorganization transaction was to resolve that problem." *Id.* at 1527 n.16.

48. 949 F.2d 341 (10th Cir. 1991).

49. I.R.C. § 6020(b)(1) (1988). The substitute return may be prepared on a Form 1040, *In re* Chastang, 116 B.R. 833 (Bankr. M.D. Fla. 1990), or on a Form 870, *In re* D'Avanza, 101 B.R. 787 (Bankr. M.D. Fla. 1989).

required, was not filed.[50] The issue in *Bergstrom* was whether a substitute return prepared by the IRS, but never signed by the taxpayer, constitutes a "filed" return for purposes of the Bankruptcy Code, so that the tax shown on the substitute return is dischargeable in a Chapter 7 liquidation.

B. *Facts*

Bergstrom had failed to file federal income tax returns for 1979, 1980 and 1981. The IRS prepared substitute returns for those years. Bergstrom did not participate in the preparation of the substitute returns, nor did he sign them. The substitute returns calculated Bergstrom's tax liability based upon information obtained from his W-2 and 1099 forms; however, the returns did not include any deductions. Based upon the substitute returns, Bergstrom was mailed a statutory notice of deficiency for each of the three years.

Subsequent to receiving the notice of deficiency, Bergstrom filed a Chapter 7 bankruptcy petition. The case was determined to be a "no asset" case, and a final decree was entered on April 12, 1989. However, the bankruptcy court subsequently reopened the case on Bergstrom's motion when the IRS began collection proceedings based on claimed deficiencies arising from the 1979, 1980 and 1981 notices of deficiency. Bergstrom then filed a motion to determine tax liability, which the bankruptcy court denied. Bergstrom appealed the denial to the district court, which affirmed. In its "Order Affirming Decision of Bankruptcy Court With Findings,"[51] the district court found that the issues raised in the case were matters of first impression in the Tenth Circuit, and that the body of law in the area was sparse.[52] Bergstrom appealed to the Tenth Circuit.

C. *The Tenth Circuit's Opinion*

To determine whether substitute returns prepared by the IRS should be considered filed returns for purposes of the Bankruptcy Code discharge rules, entitling Bergstrom to a discharge of the tax liability arising out of the substitute returns filed for him, the Tenth Circuit[53] first considered the language of section 523(a) of the Bankruptcy Code.[54] The court found that this statute clearly provides that "[a]n individual's tax liability is nondischargeable in bankruptcy when the lia-

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50. 11 U.S.C. § 523(a)(1)(B)(i) (1988).

51. The district court decision was unreported.

52. *Bergstrom*, 949 F.2d at 342.

53. Chief Judge McKay, Judge Barrett and Judge Brorby constituted the three-judge panel.

54. 11 U.S.C. § 523(a) (1988) provides in relevant part that:

> (a) A discharge under Section 727, . . . does not discharge an individual debtor from any debt—
> (1) for a tax . . .
> (B) with respect to which a return, if required—
> (i) was not filed . . . .

bility results from the individual's failure to file a return."[55] The Tenth Circuit noted that the legislative history of this section also provides that "included in the nondischargeable debts are taxes for which the debtor had not filed a required return as of the petition date or for which a return had been filed beyond its last permitted due date."[56] "[T]he debtor should not be able to use bankruptcy to escape these kinds of taxes [arising from his deliberate misconduct]. Therefore, these taxes have no priority in payment from the estate that survive as continuing debts after the case."[57]

The Tenth Circuit then disagreed with the district court's conclusion that the body of law in this area was sparse. In fact, the Tenth Circuit noted, "[m]any other courts have addressed the issue of whether a substitute return constitutes a filed return, and they have found that it does not."[58] In *In re Pruitt*,[59] the law and its policy underpinnings were succinctly stated as follows:

> Plaintiff's interpretation of 26 U.S.C. § 6020 and § 523(a)(1)(B), would result in encouragement of non-filing of tax returns. Any taxpayer could simply refuse to file a tax return for a taxable year. Eventually, the IRS would file a substitute return on behalf of the taxpayer pursuant to § 6020. The filing of such a substitute return is a simple administrative step which allows the assessment and collection process to begin. The result of completing this necessary IRS administrative procedure would be to effectively excuse the non-filing taxpayer from his own deliberate misconduct. After a few years the taxes would then be ordinarily dischargeable. Such an interpretation would render § 523(a)(1)(B) a nullity.
>
> The plain language of the section, as well as the purpose behind its enactment, require that the debtors have filed the return.[60]

In the Tenth Circuit's view, the provisions of the Code allowing the Secretary to prepare a substitute return "provides the IRS with some recourse if a taxpayer fails to file a return . . . but . . . it does not excuse a taxpayer from the filing requirement."[61] Finding itself in complete ac-

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The rule is equally applicable to discharges under Chapter 11 and Chapter 13.

55. *Bergstrom*, 949 F.2d at 342.

56. S. REP. No. 95-989, 95th Cong., 2d Sess. 78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5864.

57. S. REP. No. 95-1106, 95th Cong., 2d Sess. 22 (1978).

58. *Bergstrom*, 949 F.2d at 343. The cases include *In re* Wrench, 129 B.R. 649, 651 (Bankr. D. Kan. 1991); *In re* Chastang, 116 B.R. 833, 834 (Bankr. M.D. Fla. 1990); *In re* Crawford, 115 B.R. 381, 382-83 (Bankr. N.D. Ga. 1990) ("The return must have been filed by the debtor in order for the tax obligation to be dischargeable under § 523(a)(1)(B)."); *In re* D'Avanza, 101 B.R. 787, 789 (Bankr. M.D.Fla. 1989); *In re* Hofmann, 76 B.R. 853, 854 (Bankr. S.D. Fla. 1987); *In re* Haywood, 62 B.R. 482, 485 (Bankr. D. Ill. 1986) (Section 523(a)(1)(B) was meant to "encourage honest and self-generated reporting by taxpayers, not to immunize non-reporting debtors who, once caught, seek to discharge their discovered tax obligations along with other debts in Bankruptcy.").

59. 107 B.R. 764 (Bankr. D. Wyo. 1989).

60. *Id.* at 766.

61. *Bergstrom*, 949 F.2d at 343.

cord with the prior decisions, and unwilling to allow Bergstrom to receive any advantage from his failure to file returns for the years in question, the Tenth Circuit held that "substitute returns do not constitute filed returns in the absence of the signature of the taxpayer."[62] Although conceding that substitute returns prepared by the Secretary are considered to be "prima facie good and sufficient for all legal purposes"[63] by the Code, the Tenth Circuit nevertheless concluded that the return prepared by the Secretary "must be signed by the delinquent taxpayer before it can be accepted as the filed return of the taxpayer."[64] Bergstrom had never signed the substitute returns; therefore, they could not be considered "filed" by him, and no discharge of the tax liability arising from the returns was available.

In a related issue, Bergstrom had contended that penalties assessed in connection with the substitute returns were dischargeable because they were imposed on an event which occurred more than three years prior to the filing of bankruptcy.[65] The district court had agreed with the IRS that such penalties were not dischargeable. However, in a later case,[66] the Tenth Circuit held that tax penalties assessed in connection with tax years more than three years prior to the filing of bankruptcy were dischargeable. Therefore, the Tenth Circuit reversed the determination of the district court, and held that the penalties imposed on Bergstrom's 1979, 1980 and 1981 federal income tax returns were dischargeable because they related to an event occurring more than three years prior to his 1988 bankruptcy petition.

D. *Summary*

Although a matter of first impression in the Tenth Circuit, the nondischargeability of tax liabilities arising from the filing of a substitute return is supported by substantial law in the bankruptcy area.[67] *Pruitt* well articulates the strong and persuasive policy reasons for the requirement that discharges are only available for returns actually "filed" by the debtor. As now acknowledged by the Tenth Circuit, taxpayers should not be rewarded in bankruptcy by extending discharges to them as to tax liabilities that they have attempted to keep secret and have not voluntarily reported.

III. Presumption of Correctness Afforded to Statutory Notices of Deficiency: *Erickson v. Commissioner*[68]

A. *Background*

Notices of deficiency issued by the Commissioner of Internal Reve-

62. *Id.*
63. I.R.C. § 6020(b)(2) (1988).
64. *Bergstrom*, 949 F.2d at 341. *See* I.R.C. § 6020(a) (1988).
65. *See* 11 U.S.C. § 523(a)(7)(B) (1988).
66. *In re* Roberts, 906 F.2d 1440 (10th Cir. 1990).
67. *See supra* note 58.
68. 937 F.2d 1548 (10th Cir. 1991).

nue ("the Commissioner") in a civil tax case[69] are presumptively correct, and the taxpayer who wishes to challenge the notice bears the burden of coming forward with sufficient evidence to overcome the presumption of correctness.[70] However, there must be *some* reasonable foundation for the notice in order to preserve the presumption, and where the notice lacks a rational basis, the presumption does not apply.[71] Thus, purely arbitrary notices are not entitled to a presumption of correctness.[72] In *Erickson*, the Tenth Circuit was asked to apply these standards to a notice of deficiency issued to a convicted drug trafficker.

A related issue raised by *Erickson* involves the manner in which the Commissioner will be allowed to reconstruct a taxpayer's taxable income to provide a mathematical basis for the deficiency asserted in the notice. It is well-established that the Commissioner has

> great latitude in making determinations of liability, particularly where the taxpayer files no returns and refuses to cooperate in the ascertainment of his income. Thus, [the Commissioner] is entitled to use any reasonable means of reconstructing income. Further, he is given greater latitude in determining which method of reconstruction to apply where the case involves an illegal enterprise in which the taxpayer has failed to file a return and has kept no records.[73]

One method of reconstructing income, the cash expenditures method of reconstruction, assumes "absent some explanation by the taxpayer, that the amount by which a taxpayer's expenditures during a taxable period exceed his reported income has taxable origins."[74]

B. *Facts*

In May 1983, Sidney Erickson took off from Belize in a Cessna 404. The flight was monitored by United States customs officers through the use of a transponder planted in the Cessna. Erickson was arrested after his plane was forced down by the officers onto an airfield in Moses, New Mexico. Erickson was the sole occupant of the plane, which was found to contain approximately 2420 pounds of marijuana. Erickson was subsequently convicted in federal court of importing marijuana and possessing it with intent to distribute, and his conviction was affirmed by the Tenth Circuit in 1984.[75]

Erickson maintained three bank accounts in various locations, each

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69. *See* I.R.C. § 6212 (1988).

70. Welch v. Helvering, 290 U.S. 111, 115 (1933); Jones v. Commissioner, 903 F.2d 1301, 1303 (10th Cir. 1990); Zell v. Commissioner, 763 F.2d 1139, 1141 (10th Cir. 1985). If the taxpayer can rebut the presumption, the burden of proof shifts to the Commissioner.

71. *Jones*, 903 F.2d 1301, 1304 (10th Cir. 1990); Llorente v. Commissioner, 649 F.2d 152, 156 (2d Cir. 1981).

72. *Llorente*, 649 F.2d at 156.

73. Carson v. United States, 560 F.2d 693, 693-94 (5th Cir. 1977).

74. Erickson v. Commissioner, 937 F.2d 1548, 1553 (10th Cir. 1991); Burgo v. Commissioner, 69 T.C. 729, 742 (1978).

75. United States v. Erickson, 732 F.2d 788 (10th Cir. 1984).

of which reflected very low balances in 1983. Nevertheless, Erickson had managed to pay for various expenses in 1983 totalling approximately $75,000 in either cash or cashier's checks.[76] Erickson owned a second plane and maintained a hangar in Grand Junction, Colorado, and some of his expenses related to the maintenance of the plane and the hangar. Additionally, the Commissioner estimated Erickson's purchase price for the 2420 pounds of marijuana at $200,000.

In 1984, the Commissioner issued a statutory notice of deficiency to Erickson, which reconstructed his income by reference to his cash expenditures.[77] Upon review of a petition filed by Erickson, the Tax Court upheld the Commissioner's determination[78] despite Erickson's claim that the 1984 notice of deficiency was unsupported by any factual basis and was therefore arbitrary and erroneous. Erickson appealed to the Tenth Circuit, which affirmed.

C. *The Tenth Circuit's Opinion*

On appeal, Erickson argued that there was an insufficient factual basis to support the presumed correctness of the 1984 notice of deficiency, unless the Commissioner could produce evidence directly connecting him to the business of illegal drug activity as a source of taxable funds, *i.e.*, proof of drug sales or proof that he actually purchased the marijuana. The Tenth Circuit[79] disagreed, holding that the Commissioner was only required to link Erickson to the liquid assets connected to the activity to preserve the presumption. Summarizing prior cases,[80] the court stated the following:

> Once the Commissioner demonstrated sufficient minimal facts to show an ownership interest in assets possessed by the taxpayers, the presumption of correctness remained with the notice of deficiency and the taxpayers had the burden of satisfactorily explaining how they came to possess the liquid assets, and to show why the assets did not represent taxable income in the year in question.[81]

Erickson apparently argued, at least implicitly, that he was merely a pilot-for-hire, or "mule," and did not have an ownership interest in the marijuana. This argument, however, was not necessarily supported by

76. These expenditures included the payment of his appearance bond in the amount of $50,000, paid to the Clerk of the Court in Albuquerque, New Mexico in $20 bills.

77. Including the estimated $200,000 purchase price for the marijuana and the $50,000 appearance bond, these expenditures totalled to $275,079. The notice of deficiency asserted an income tax deficiency for 1983 in the amount of $202,217 including additions to tax.

78. Erickson v. Commissioner, 58 T.C.M. (CCH) 352 (1989).

79. Judge Anderson and Judge McWilliams, together with Judge Wayne E. Alley, United States District Court for the Western District of Oklahoma, sitting by designation, made up the three-judge panel.

80. Delaney v. Commissioner, 743 F.2d 670 (9th Cir. 1984); Schad v. Commissioner, 87 T.C. 609 (1986), *aff'd without published opinion*, 827 F.2d 774 (11th Cir. 1987); Tokarski v. Commissioner, 87 T.C. 74 (1986).

81. Erickson v. Commissioner, 937 F.2d 1548, 1551-52 (10th Cir. 1991).

the record[82] and, on balance, the Tenth Circuit viewed Erickson's cash transactions and his ownership of a hangar and two planes as consistent with a proprietary interest in the plane's cargo.

The possession or ownership of marijuana, of course, is not a taxable transaction. Erickson's ownership or possessory interest in the seized marijuana would be relevant to the presumed correctness of the notice of deficiency only if it was probative of associated transactions indicating cash receipts by Erickson that would be taxable. The question thus became whether Erickson's possession of the marijuana was sufficient evidence of cash transactions entered into by him in connection with an income-producing activity.

The Tenth Circuit disposed of this question by recognizing the cash-intensive nature of the drug trade. The court stated that it was not an

> impermissible stretch to assume that someone who is importing more than a ton of marijuana into the United States by air paid for the drugs in cash at a time proximate to the date of the shipment. This is enough to provide a rational underpinning for the notice of deficiency. . . .[83]

The Tenth Circuit thus allowed the Commissioner to "boot-strap" his way to showing that Erickson possessed taxable funds, by pointing to the fact that Erickson was in possession of a commodity generally known to trade only in a cash market.[84]

The Tenth Circuit would have sustained the notice of deficiency based solely on the Commissioner having provided a factual foundation upon which it was rational to conclude that Erickson had an ownership or possessory interest in the marijuana, and thus funds that (in the absence of an explanation) were taxable. Both Erickson and the government, however, apparently believed that it was necessary to examine the government's actual application of the cash expenditures method of income reconstruction utilized to generate the notice of deficiency. Erickson argued that the Commissioner's application of the cash expenditures method of income reconstruction was deficient in this case because the Commissioner had failed to establish Erickson's net worth at the beginning and the end of taxable year 1983. According to Erickson, the failure of the Commissioner to do so precluded the Commissioner from ruling out the possibility that Erickson's cash expenditures

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82. During the course of the criminal proceedings, Erickson had filed a motion to suppress on the basis that he had a reasonable expectation of privacy in the airplane, which had been violated by the government when it installed the transponder to monitor the flight. Following a suppression hearing, the district court determined that Erickson had failed to establish a legitimate expectation of privacy by proving lawful ownership or a sufficient possessory interest in the plane containing the marijuana. However, during that hearing, Erickson admitted that he had an "ownership or possessory interest" in the marijuana cargo. *Id.* at 1549.

83. *Id.* at 1552.

84. The Tenth Circuit reserved judgment on the situation where the taxpayer is in possession or has ownership of *illiquid* assets. "In a proper case such evidence may provide sufficient linkage to other evidence to justify a notice of deficiency." *Id.* at 1552 n.4.

in 1983, including those made to purchase the marijuana, came from savings derived from a nontaxable or previously taxed source of funds owned by Erickson at the beginning of the year but dissipated by the time of his arrest.

The Tenth Circuit refused to accept the proposition that the Commissioner must establish opening and closing net worths "for drug traffickers who specialize in secrecy, deception, and evasion."[85] To retain the presumption of correctness for the notice of deficiency, "the Commissioner is not obliged to establish a net worth when applying the cash expenditures method for notices of deficiency in civil tax cases"[86] if the Commissioner has reasonably linked the taxpayer to specific expenditures in issuing a notice of deficiency based on those expenditures. The Tenth Circuit thus upheld the Tax Court's determination that Erickson had failed to carry his burden of proving that the notice of deficiency was arbitrary or erroneous.[87]

D. *Summary*

The Tenth Circuit viewed the *Erickson* case as one "which has been searching for a coherent legal theory in the wrong places."[88] Although both the taxpayer and the government had apparently spent considerable energy addressing the technical requirements of the cash expenditures method of reconstructing income, "[t]here is only one rule, that there be some rational underpinning [for the notice of deficiency]. Establishing a minimal evidentiary foundation can be done in a variety of ways, and no rigid formulations are required."[89] Here, the Commissioner had established a rational basis for the notice of deficiency by providing a factual foundation linking Erickson to a source of unreported income. Having thus preserved the notice's presumption of correctness, the Commissioner prevailed on the overall merits when the taxpayer offered no evidence to overcome the presumption.

While *Erickson* seems to provide a relatively lax evidentiary hurdle for the Commissioner to clear in preserving the presumption of correctness afforded to his notices of deficiency, the factual setting should be kept in mind. The Tenth Circuit has shown itself to be fairly open-minded in considering taxpayer challenges to the correctness of notices of deficiency in other contexts. At the end of 1991, in *Hagen v. Commis-*

85. *Id.* at 1554. The Tenth Circuit viewed this undertaking as a "daunting burden" and one "likely to be so wildly inaccurate through no fault of the Commissioner as to be of little real probative value." *Id.*

86. *Id.*

87. A finding by the Tax Court that a taxpayer has failed to carry his burden of proving that the notice of deficiency is arbitrary or erroneous is factual and may not be set aside unless clearly erroneous. 26 U.S.C. § 7482(a) (1988); FED. R. CIV. P. 52(a); Marathon Oil Co. v. Commissioner, 838 F.2d 1114 (10th Cir. 1987); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987). On the other hand, findings of law and of ultimate fact are subject to *de novo* review. Pollei v. Commissioner, 877 F.2d 838 (10th Cir. 1989).

88. *Erickson*, 937 F.2d at 1555.

89. *Id.*

sioner,[90] the Tenth Circuit concluded that the taxpayer had made a legitimate challenge to the reasonableness of the method used by the IRS to reconstruct his income,[91] and that the IRS had not adequately responded to the challenge in its brief on appeal. The case was remanded to determine if the IRS could adequately address the taxpayer's arguments and establish a rational basis for the method it used to calculate the asserted deficiencies. Thus, although the presumption of correctness is strong, it *can* be overcome and the burden can be shifted to the IRS by showing that the underlying theory of income reconstruction is faulty or illogical.

IV. Guarantee by Shareholder of S Corporation's Debt Does Not Create Basis in Shareholder's Stock: *Goatcher v. United States*[92] and *Uri v. Commissioner*[93]

A. *Background*

Under Subchapter S of the Code, corporations may elect to be treated as pass-through entities for federal income tax purposes.[94] Corporations filing the appropriate election, and thereby becoming "S corporations," will be treated in a manner similar, although not identical, to partnerships. Items of an S corporation's income, gain, loss, deduction and credit are not taxed to the corporation, but are "passed through" and allocated among its shareholders on a *pro rata* basis, based upon the shareholders' relative interests in the corporation.[95]

An S corporation that generates a taxable loss during the year must allocate that loss *pro rata* among its shareholders. However, the aggregate amount of losses and deductions that may be taken into account and deducted by a shareholder in an S corporation for any taxable year may not exceed the sum of the adjusted basis of the shareholder's stock in the corporation[96] and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.[97] A shareholder in an S

90. The Order and Judgment of the Tenth Circuit is unpublished, but can be found at 92-1 U.S. Tax Cas. (CCH) ¶ 50,030. The Order and Judgment has no precedential value and may not be cited or used by any court within the Tenth Circuit, except for purposes of establishing the doctrines of law of the case, res judicata, or collateral estoppel. 10th Cir. R. 36.3.

91. The method at issue was the bank deposits method of income reconstruction, which reconstructs income by reference to deposits and withdrawals from the taxpayer's bank accounts. The taxpayer was a registered securities broker-dealer, and he argued that the IRS had not valued his beginning and closing inventories of securities properly and had not appropriately reconstructed the manner in which he should report short sales. Ultimately, this method was claimed to illogically reflect the taxpayer's cost of goods sold as reflected in the notice of deficiency.

92. 944 F.2d 747 (10th Cir. 1991).

93. 949 F.2d 371 (10th Cir. 1991).

94. I.R.C. §§ 1361-1379 (1988). A Subchapter S election can be made if the definitional requirements of I.R.C. § 1362 are satisfied.

95. *Id.* § 1366(a).

96. *Id.* § 1366(d)(1)(A).

97. *Id.* § 1366(d)(1)(B). The basis of the shareholder in her stock (and in the indebtedness of the S corporation owed to her) is increased and decreased pursuant to the adjustment and ordering rules set forth in I.R.C. § 1367.

corporation that is expected to generate substantial operating losses is therefore well advised to structure his affairs to maximize the basis of his stock in the S corporation, and not unduly "waste" the resulting loss deduction.[98]

When an S corporation needs to borrow funds, tax counselors generally advise that the shareholders, rather than the corporation, obtain the loan and then either contribute the loan proceeds to the corporation as a contribution to capital, thus increasing the shareholders' bases in their stock, or loan those proceeds to the corporation, thus creating basis in the form of indebtedness of the corporation to the shareholders. Occasionally, shareholders do not receive or heed such advice,[99] and later argue that the manner in which the funds were actually borrowed nevertheless created additional basis for the shareholders, against which they may claim allocable losses of the S corporation. This situation typically occurs when the corporation borrows the funds directly and the shareholders guarantee repayment of the loan. The shareholders then argue that the guarantee is akin to a capital contribution to the corporation, thus increasing the basis of their stock.

Courts have been split as to whether a shareholder of an S corporation may successfully claim that the adjusted basis in his stock includes a *pro rata* share of the amount of a corporate loan he personally guarantees. In *Selfe v. United States*,[100] the Eleventh Circuit approved a theory of prorated inclusion of personal loan guarantees in basis. The Eleventh Circuit looked to whether the lender relied primarily on the shareholder or the corporate entity for repayment of the loan, and remanded the case for a factual determination of this issue. In *Estate of Leavitt v. Commissioner*[101] and *Brown v. Commissioner*,[102] the Fourth and Sixth Circuits, respectively, disapproved the *Selfe*-type analysis, determining that S corporation shareholders must abide by the form of the transaction as structured by them, "rather than using hindsight to construct an explanation of the transaction which gives them the best tax result."[103] Under this analysis, the S corporation shareholder must actually be called upon to make good on the loan and, once having made payment on the loan, may add the amount of that payment to the basis of his stock.

B. *Facts and the Tenth Circuit's Opinions*

The taxpayers in *Goatcher* were a husband and wife who had formed

98. Under I.R.C. § 1366(d)(2), any loss or deduction which is disallowed for any taxable year by reason of the basis limitations is treated as having been incurred by the corporation in the succeeding taxable years with respect to that shareholder; that is, there is an indefinite carry-over of the disallowed loss or deduction, which may be claimed by the shareholder only when she has developed additional basis in her S corporation stock.

99. Of course, in some cases, practical, legal, or financial considerations may preclude such an arrangement.

100. 778 F.2d 767 (11th Cir. 1985).

101. 875 F.2d 420 (4th Cir.), *cert. denied*, 493 U.S. 958 (1989).

102. 706 F.2d 755 (6th Cir. 1983).

103. Uri v. Commissioner, 949 F.2d 371, 373 (10th Cir. 1991).

an Oklahoma corporation electing status as an S corporation to construct and operate a cable TV system in four Oklahoma communities. After contributing $1000 to the capital of the corporation, the shareholders caused the corporation to borrow in excess of $1,000,000 in a series of loans that were personally guaranteed by the taxpayers. The taxpayers were never called upon to pay the guarantees. In 1982 and 1983, the corporation generated approximately $91,000 of operating losses, which the taxpayers claimed on their personal income tax returns. The IRS limited the pass-through of these losses to the amount of the taxpayers' $1000 initial capital contribution. After unsuccessfully suing the government in district court for the amount of the resulting tax deficiency,[104] the taxpayers appealed to the Tenth Circuit, which affirmed.

The Tenth Circuit[105] adopted the reasoning of *Leavitt*, holding that there must be an economic outlay on the part of the shareholder to increase the basis of his stock in an S corporation.[106] A personal guarantee, in and of itself, does not satisfy the economic outlay requirement, being merely a promise to pay in the future if called upon to do so. The taxpayers predictably argued that, *in substance*, the guarantee amounted to a loan to the taxpayers followed by their contribution of the loan to the corporation. While sympathetic to the plight of the taxpayers, the Tenth Circuit did not feel itself "free to call a carrot a cabbage to achieve a desired result"[107] and affirmed the district court's denial of the loss deductions.

Uri involved two taxpayers, Cathaleen Uri and Stevens Townsdin, who were partners in an accounting firm. In 1980, the taxpayers had formed The Old Opera House Mall Company, a Kansas corporation that elected to be taxed as an S corporation, for the purposes of renovating a building in downtown Concordia, Kansas, and opening a small shopping mall on the premises. Uri and Townsdin each contributed $10,000 in cash to capitalize the corporation, and each received 50% of its stock. The corporation then borrowed money from a local bank to repay interim loans for construction and equipment. The loan was secured by the real estate and assets of the corporation, and by the personal guarantees of Uri and Townsdin. The Small Business Administration ("the SBA") also guaranteed 90% of the loan.

The mall opened in July 1981, but by July 1982 had ceased all retail operations. The SBA sent Uri and Townsdin demands under their guarantees after the note went into default and was accelerated. In response, both Uri and Townsdin filed petitions under Chapter 7 of the Bankruptcy Code, and the personal guarantees were discharged. Ultimately, the corporation also filed for Chapter 7 liquidation. The Commissioner

104. The decision of the district court was unreported.

105. Judge Anderson, Judge Tacha and Judge Brorby constituted the three-judge panel.

106. Goatcher v. United States, 944 F.2d 747, 751 (10th Cir. 1991).

107. *Id.* at 752.

disallowed all pass-through corporate losses to the shareholders in excess of their $10,000 capital contributions for tax years 1982 and 1983. The taxpayers filed unsuccessful petitions in the Tax Court[108] and appealed to the Tenth Circuit.

The Tenth Circuit[109] was unmoved by the taxpayers' apparent contention that the Chapter 7 liquidations somehow differentiated their case from *Goatcher, Leavitt, Brown* and *Harris v. United States*.[110] The significant personal loss suffered by them in bankruptcy did not satisfy the requirement that there be an actual economic outlay by the shareholders with respect to the guarantee in order to create additional basis in their stock.[111]

C. *Summary*

The Tenth Circuit has clearly rejected *Selfe* in favor of the more rigid requirement that taxpayers must follow the road map set out in the Code to receive basis credit for loans to S corporations. Arguments of "substance over form" will not carry the day for S corporation shareholders who fail to properly structure their affairs. The treatment of S corporation loans is simply another area of tax law where form must be scrupulously observed if the desired tax results are to be achieved.[112] If the shareholders of an S corporation in the Tenth Circuit are to maximize their ability to claim their allocable share of the corporation's operating losses, any loan to the S corporations should first be carefully structured as a loan to the shareholders and not to the corporation. The shareholders must then either contribute the proceeds of the loan to the corporation, or loan the proceeds to the corporation, to receive "credit" in calculating the shareholders' bases in their S corporation stock or debt against which they may claim such losses.

V. Authority of the Commissioner to Require Changes in Accounting Methods: *Ralston Development Corp. v. United States*[113]

A. *Background*

The Code provides that whenever the use of inventory is necessary in order clearly to determine the income of any taxpayer, inventory is to

108. Uri v. Commissioner, 56 T.C.M. (CCH) 1217 (1989).

109. Judge Holloway, Judge Baldock and Judge J. Thomas Greene, United States District Court for the District of Utah, sitting by designation, made up the three-judge panel.

110. 902 F.2d 439 (5th Cir. 1990). In *Harris*, the Fifth Circuit joined the Fourth and Sixth Circuits in their treatment of this issue, leaving the Eleventh Circuit alone in its "facts and circumstances" analysis.

111. The taxpayers in *Uri* had also argued that the loan was in substance a loan to the taxpayers and a subsequent contribution by them of funds to the corporation because it had been made by the lender primarily on its assessment of, and reliance upon, the strength of the taxpayers' personal financial worth and income. This argument was unsuccessfully made in *Goatcher* and was rejected here as well.

112. *Cf. supra* note 43.

113. 937 F.2d 510 (10th Cir. 1991).

be taken by the taxpayer on such basis as the IRS may prescribe "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."[114] Under the applicable Treasury Regulations, the taking of inventory and the utilization of an appropriate inventory accounting method are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.[115]

The Regulations further state that in "any case in which it is necessary to use an inventory, the accrual method of accounting *must* be used with regard to purchases and sales unless otherwise authorized."[116] However, the Commissioner *may* authorize a taxpayer "to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized . . . *if, in the opinion of the Commissioner, income is clearly reflected* by the use of such method."[117] *Ralston Development Corp.* presented the Tenth Circuit with an opportunity to apply the "clear reflection of income" test for the first time in the circuit.

B. *Facts*

Ralston Development Corp. was engaged in the business of manufacturing water treatment control system parts and components. These water control systems were apparently sold to Ralston's customers and maintained by Ralston under maintenance contracts. For many years, Ralston had used the accrual method of accounting for financial statement purposes, but had used the cash receipts and disbursements method of accounting in preparing its federal income tax returns.[118]

114. I.R.C. § 471 (1988). Generally speaking, the issues arising under inventory accounting include such questions as whether the basis of valuation is to be cost or lower of cost or market; whether the inventory flow assumption is to be last-in, first-out (LIFO), first-in, first-out (FIFO), or some other assumption; and whether the "full absorption" method of inventory costing for manufacturers has been properly applied. None of these issues were presented in *Ralston Development Corp.* Rather, the case centered around the broader question of whether Ralston was entitled to use the cash receipts and disbursements method of accounting, as opposed to the accrual method of accounting insisted upon by the IRS.

115. Treas. Reg. § 1.471-1 (1960). Under Treas. Reg. § 1.471-2 (as amended in 1973), it is acknowledged that I.R.C. § 471 provides two tests which each inventory accounting method must satisfy. The method must (1) conform as nearly as possible to the best accounting practice in the trade or business; and (2) clearly reflect income.

116. Treas. Reg. § 1.446-1(c)(2)(i) (as amended in 1987) (emphasis added). The Tenth Circuit did not focus on the possible argument that Ralston was not engaged in the purchase and sale of inventory, but was rather a manufacturer. It does not seem inappropriate, however, to require manufacturers to use accrual accounting if merchandising organizations must use that method.

117. *Id.* § 1.446-1(c)(2)(ii) (emphasis added). It should be noted that, for tax years beginning after December 31, 1986, a "C corporation"—which is presumably the type of entity selected by Ralston—may not use the cash receipts and disbursements method of accounting unless it is a "qualified personal service corporation" or has gross receipts of not more than $5,000,000. I.R.C. § 448 (1988).

118. Under the cash receipts and disbursements method of accounting, "all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received" and expenditures "are to be deducted for the taxable year in which actually made." Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1987).

Although Ralston's federal income tax returns had been audited several times over the years, the IRS had always approved Ralston's use of the cash method for federal income tax purposes.

Ralston was once again audited in 1982, for its 1979, 1980, and 1981 tax years. As a result of this audit, the IRS determined that Ralston's use of the cash method of accounting did not clearly reflect Ralston's income, and required that Ralston switch to the accrual method of accounting.[119] This and other adjustments resulted in sizeable tax deficiencies for 1980 and 1981, which Ralston paid and for which Ralston instituted a refund action in district court. A jury trial resulted in a judgment for Ralston.[120] The government appealed to the Tenth Circuit, which reversed.

C. *The Tenth Circuit Opinion*

On appeal,[121] Ralston conceded that inventories were a income-producing factor in its business. Therefore, the issue was whether the IRS had abused its discretion in determining that the cash method of accounting utilized by Ralston did not clearly reflect its income.[122] If the cash method of accounting did not clearly reflect Ralston's income, the accrual method would be mandated.[123]

The test developed by courts to determine whether a particular accounting method clearly reflects income has come to be known as the "substantial identity of results" test. Under this test, a taxpayer's method of accounting is "sustainable only if it achieves results that are virtually identical to the results that would be achieved under an accrual method."[124] This somewhat harsh test reflects the high degree of deference that courts consistently pay to the Commissioner in reviewing an IRS determination that a particular accounting method used by a taxpayer with inventories does not clearly reflect income.[125]

In *Ralston*, there were substantial differences between the results

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119. Under the accrual method of accounting,

> income is to be included for the taxable year when all the events have occurred which tax the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

Id. § 1.446-1(c)(1)(ii).

120. There was no reported decision at the district court level.

121. The three-judge panel consisted of Judge Logan, Judge Moore and Judge J. Thomas Greene, United States District Court for the District of Utah, sitting by designation.

122. The accrual method insisted upon by the Commissioner applied to Ralston's entire accounting system, not just to its inventories. "If the taxpayer must use inventories, the Commissioner may also require it to adopt the accrual method." Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 789 (11th Cir. 1984). Of course, the greatest monetary impact resulting from such a switch will be felt in the inventory area, since the purchase and sale of inventory will comprise the largest element of taxable income.

123. Treas. Reg. §§ 1.446-1(c)(2)(i) and (ii) (as amended in 1987).

124. Ralston Development Corp. v. United States, 937 F.2d 510, 513 n.4 (10th Cir. 1991) (citation omitted).

125. *See, e.g.*, Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-33 (1979).

obtained under the accrual method of accounting and the cash method of accounting. The difference was apparently attributable to the fact that certain contract retentions recognized by Ralston delayed the inclusion in income of various amounts otherwise receivable from customers purchasing the water control systems. Under the cash method of accounting employed by Ralston, those receivables would not be included in income until received. Under the accrual method of accounting, the receivables would be currently included in income and matched against the related expenses incurred by Ralston in the construction of the water control systems. When compared to the use of the cash method of accounting, utilization of the accrual method increased Ralston's gross income by 157% in 1979, 36% in 1980 and 48% in 1981.[126]

Ralston argued that, notwithstanding these differences, the use of the cash method of accounting, consistently applied over the years, "clearly reflected" its income for the years in question. The Tenth Circuit's response is indicative of the high burden that taxpayers carry in contending that some method of accounting, other than one sanctioned by the IRS in the particular circumstance, clearly reflects income. The Tenth Circuit simply viewed these contentions as essentially irrelevant in the face of the fact that Ralston's cash method of accounting yielded results that were not consistent with the accrual method of accounting prescribed by the IRS.[127] Ralston had not contested the government's calculation of the substantial differences achieved under the two methods of accounting for the years in question; thus, the Tenth Circuit had little choice but to reverse the district court and uphold the Commissioner's imposition of the accrual method of accounting.

D. *Summary*

Ralston Development Corp. is illustrative of the considerable burden borne by taxpayers in the Tenth Circuit who use an accounting method other than the accrual method prescribed by the IRS if those taxpayers utilize inventories that are an income-producing factor. Unless the two methods achieve a substantial identity of results, so that there is virtually no difference between the two methods with respect to their impact on the taxpayer's taxable income, the Commissioner's determination will prevail, even if the taxpayer's method clearly reflects income in a general sense.

126. *Ralston Development Corp.*, 937 F.2d at 513.

127. In fact, courts have upheld the determination of the Commissioner where the differences between the method preferred by the taxpayer and the method prescribed by the Commissioner have been almost nonexistent. For example, in Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970), the First Circuit held that the Commissioner did not abuse his discretion when the difference between the two methods over the course of five years was less than two-tenths of one percent. *Id.* at 356.

VI. NO JUDICIAL REVIEW FOR INTERNAL REVENUE SERVICE'S REFUSAL TO ABATE INTEREST UNDER I.R.C. § 6404(E)(1): *SELMAN V. UNITED STATES*[128]

A. *Background*

If the amount of any tax imposed under the Code is not paid on or before the last date prescribed for payment, interest on the underpayment is imposed from the due date to the date paid[129] at statutorily prescribed rates.[130] The Internal Revenue Service has consistently taken the position that it does not have the statutory authority to abate this interest.[131] However, new I.R.C. § 6404(e)(1), enacted as part of the Tax Reform Act of 1986, now authorizes the Secretary of the Treasury to abate interest to the extent that it is attributable to IRS errors or delays in performing ministerial acts.[132] *Selman* examined whether a taxpayer may obtain judicial review of an IRS decision not to abate interest.

B. *Facts*

Robert Selman's 1981 and 1982 tax returns were audited in 1984. The audit was concluded in 1985, and the IRS assessed substantial tax deficiencies. Selman timely filed a written protest to the proposed adjustments. It was not until May 1987 that Selman and the IRS reached a tentative settlement agreement. The settlement agreement was accepted by the Commissioner in August 1987, and the IRS assessed a deficiency for 1981 and 1982, together with statutory interest for the period during which the deficiency was outstanding.

In October 1987, before paying the assessed interest, Selman filed a request with the IRS to abate a portion of the interest pursuant to the provisions of I.R.C. § 6404(e)(1).[133] Selman's argument was that the

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128. 941 F.2d 1060 (10th Cir. 1991).

129. I.R.C. § 6601(a) (1988).

130. *Id.* § 6621.

131. "Except as specifically provided by statute . . . there is no authority for waiving interest on delinquent taxes or for refunding on equitable grounds interest that has been legally assessed or collected." [2 Administration] I.R. Man. (CCH) pt. 5175.1(1), at 6303 (Oct. 31, 1989).

132. I.R.C. § 6404(e)(1) (1988) provides as follows:

> (E) ASSESSMENTS OF INTEREST ATTRIBUTED TO ERRORS AND DELAYS BY INTERNAL REVENUE SERVICE
>
> (1) IN GENERAL
>
> In the case of any assessment of interest on—
>
> (A) any deficiency attributable in whole or in part to any error or delay by an officer or employee of the Internal Revenue Service (acting in his official capacity) in performing a ministerial act, . . .
>
> . . . .
>
> the Secretary may abate the assessment of all or any part of such interest for any period. For purposes of the preceding sentence, an error or delay shall be taken into account only if no significant aspect of such error or delay can be attributed to the taxpayer involved, and after the Internal Revenue Service has contacted the taxpayer in writing with respect to such deficiency or payment.

133. The request is filed on Form 843. *See* Rev. Proc. 87-42, 1987-2 C.B. 589.

IRS, through its own errors or delays in performing ministerial acts,[134] had caused the accumulation of at least a portion of the interest. The IRS denied Selman's request, and over the next two years Selman paid both the assessed tax and the interest. After filing an unsuccessful claim for refund with the IRS, Selman brought a refund suit in district court, contending that the IRS had abused its discretion in denying his abatement request. The district court granted the IRS's motion to dismiss the complaint on the ground that Selman's cause of action did not fall within its subject matter jurisdiction, and alternatively, that even if the court had subject matter jurisdiction, the decision whether to abate interest was committed to agency discretion and was therefore not subject to judicial review.[135] Selman appealed to the Tenth Circuit.

C. *The Tenth Circuit's Opinion*

On appeal, the Tenth Circuit[136] affirmed the district court. Although the Tenth Circuit concluded that the district court did have subject matter jurisdiction over the action,[137] it nevertheless affirmed on the basis that the decision to abate interest is committed to agency discretion by law, and judicial review of the decision is therefore precluded.

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134. The ministerial acts were not identified in either the district court or the Tenth Circuit opinions. As to the nature of the ministerial acts envisioned, the legislative history notes that the new law

> applies only to failures to perform ministerial acts that occur after the IRS has contacted the taxpayer in writing. . . . The committee intends that the term 'ministerial act' be limited to nondiscretionary acts where all the preliminary prerequisites, such as conferencing and review by supervisors, have taken place. . . . The IRS may define a ministerial act in regulations.

S. REP. No. 99-313, 99th Cong., 2d Sess. 208-9 (1988). Temp. Treas. Reg. § 301.6404-2T(b)(1) (1987) defines a ministerial act as "a procedural or mechanical act that does not involve the exercise of judgment or discretion, and that occurs during the processing of a taxpayer's case after all prerequisites, such as conferences and review by supervisors, have taken place." Examples set forth in *id.* § 301.6404-2T(b)(2) indicate that the phrase will be narrowly construed, and specifically does not include decisions to delay examinations because of work priorities or resource limitations.

135. Selman v. United States, 733 F. Supp. 1444 (W.D. Okla. 1990). The district court followed the reasoning and conclusions of Horton Homes, Inc. v. United States, 727 F. Supp. 1450 (M.D. Ga. 1990), noting that "a case closer in point cannot be found." *Selman*, 733 F. Supp. at 1445. Addressing the identical issue, *Horton Homes* had concluded that the court lacked subject matter jurisdiction under 28 U.S.C. § 1346(a) (1988), and that even if it did have jurisdiction, the "no law to apply" standard developed in the text required a conclusion that there is no right of judicial review under the Administrative Procedures Act. On appeal, the Eleventh Circuit disagreed with the first conclusion, but agreed with the second. Horton Homes, Inc. v. Commissioner, 936 F.2d 548 (11th Cir. 1991). The procedural history of *Horton Homes* thus closely parallels that of *Selman*.

136. Judge Logan and Judge Baldock, together with Judge Myron H. Bright, United States Senior Circuit Judge for the Eighth Circuit Court of Appeals, sitting by designation, constituted the three-judge panel.

137. The jurisdictional question centered on the application of 28 U.S.C. § 1346(a)(1) (1988), which grants district courts original jurisdiction in actions brought to recover taxes "alleged to have been erroneously or illegally assessed or collected," *or* to recover "any sum alleged to have been excessive . . . under the internal-revenue laws." The district court had focused solely on the first half of the statute and dismissed Selman's complaint after concluding that his claim of abuse of discretion by the IRS did not amount to illegally or erroneously collecting a tax. The Tenth Circuit reminded the district court that it also had jurisdiction over claims based on allegedly excessive sums, and concluded that Selman's was such a claim.

Selman had contended that the Administrative Procedure Act[138] extended authority to the district court to review the actions of the IRS under the circumstances of his case. Under the Administrative Procedure Act, however, judicial review cannot be obtained where either "(1) statutes preclude judicial review; or (2) agency action is committed to agency discretion by law."[139] Since I.R.C. § 6404(e)(1) does not expressly preclude judicial review, the first exception did not apply, and attention was focused on the second exception.[140]

In considering whether the IRS's decision to abate interest under I.R.C. § 6404(e)(1) is one that is "committed to agency discretion by law," the Tenth Circuit noted that the second exception is triggered "in those rare instances where 'statutes are drawn in such broad terms that in a given case there is no law to apply.' "[141] In this connection, the Supreme Court has stated that

> even where Congress has not affirmatively precluded review, review is not to be had if the statute is drawn so that a court would have no meaningful standard against which to judge the agency's abuse of discretion. In such a case, the statute ("law") can be taken to have "committed" the decisionmaking to the agency's judgment absolutely.[142]

Selman argued that there *was* a meaningful standard against which to judge the IRS's exercise of discretion. Selman pointed to a statement in the congressional committee reports that "the provision be utilized in instances where failure to abate interest would be *widely perceived as grossly unfair*."[143] The Tenth Circuit disagreed, stating that:

> Such an amorphous statement as "widely perceived as grossly unfair" hardly provides a reviewing court with substantive standards by which to evaluate agency action .... [A]fter reviewing the statement in context, we are convinced that Congress intended this statement as an admonition to the Secretary to use this authority sparingly, not as a substantive standard defining when to abate.[144]

As further support for its conclusion, the Tenth Circuit pointed out

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138. 5 U.S.C. §§ 501-706 (1988).

139. *Id.* § 701(a).

140. In Brahms v. United States, 18 Cl. Ct. 471 (1987), the Claims Court held that a decision by the IRS not to abate interest under I.R.C. § 6404(e)(1) was not judicially reviewable. The court seemed to conclude that I.R.C. § 6404(e)(1) *was* a statute that precluded review by its terms because of the discretionary, rather than the mandatory, nature of the IRS's authority to abate interest. In *Selman*, the Tenth Circuit employed the mandatory-discretionary distinction to support its conclusion that the second exception found in 5 U.S.C. § 701(a) applies to preclude review, rather than the first.

141. Selman v. United States, 941 F.2d 1060, 1063 (10th Cir. 1991) (quoting Citizens to Preserve Overton Park v. Volpe, 401 U.S. 403, 410 (1971) (citation omitted)). At the district court level, the taxpayers had argued that the "no law to apply" standard laid down in *Overton Park* was "without foundation and fatally flawed," and urged the district court to adopt a different test. Selman v. United States, 733 F. Supp. 1444, 1446 (W.D. Okla. 1990). The district court declined the invitation to depart from Supreme Court precedent.

142. Heckler v. Chaney, 470 U.S. 821, 830 (1985).

143. H.R. REP. No. 99-426, 99th Cong., 1st Sess. 844 (1986); S. REP. No. 99-313, 99th Cong., 2d Sess. 208 (1986) (emphasis added).

144. *Selman*, 941 F. 2d at 1063-64.

that the language of I.R.C. § 6404(e)(1) is permissive, and not mandatory.[145] The Tenth Circuit also noted that the legislative history, as embodied in both the House and Senate reports, states that "[t]he Act gives the IRS the authority to abate interest *but does not mandate that it do so* (except that the IRS must do so in the case of certain erroneous refunds . . .)."[146] The distinction drawn by the legislative history between the authority and the obligation to abate interest "clearly evinces Congress's intent to commit the abatement of interest pursuant to subsection (e)(1) to the discretion of the Secretary."[147] Given the language, structure and legislative history of I.R.C. § 6404(e)(1), the Tenth Circuit concluded that "Congress meant to commit the abatement of interest to the Secretary's discretion and therefore, 5 U.S.C. § 701(a)(2) precludes judicial review."[148]

D. *Summary*

Selman is unwelcome news for taxpayers who are assessed interest on an underpayment of tax and who believe that a portion of the interest assessment is due in whole or in part to errors or delays by the IRS. Since it is now fairly established that judicial review is not available, practical experience leads one to the pessimistic conclusion that abatements under I.R.C. § 6404(e)(1) will be sparingly granted by the I.R.S.

VII. Status of Reserved Interest in Oil and Gas Lease Determined to be Overriding Royalty Rather Than Production Payment: *Yates v. Commissioner*[149]

A. *Background*

When the owner of an oil and gas lease assigns his rights in the

145. I.R.C. § 6404(e)(1) (1988) states that "the Secretary *may* abate the assessment." (Emphasis added). The word " '[m]ay,' unlike 'shall,' is not a word of command, but of permission." Bergen v. United States, 569 F.2d 1197, 1198 n.3 (Ct. Cl. 1977), *cert. denied*, 434 U.S. 939 (1977). This language is to be contrasted with the language utilized in I.R.C. § 6404(e)(2) (1988), relating to interest abatements on erroneous refund checks. There, the "Secretary *shall* abate the assessment of all interest on any erroneous refund . . . ." *Id.* (emphasis added). "The fact that Congress employed both permissive and mandatory language indicates that Congress intentionally sought to commit the former to the agency's discretion while controlling the agency's action in the latter." *Selman*, 941 F.2d at 1064.

Selman had also argued that the doctrine of "no law to apply" should be curtailed by the strong presumption favoring judicial review, which can only be overcome by clear and convincing evidence of a contrary legislative intent. *See, e.g.*, Abbott Lab. v. Gardner, 387 U.S. (1967). According to the Supreme Court, this burden can be carried "whenever the congressional intent to preclude judicial review is 'fairly discernable in the statutory scheme.' " Block v. Community Nutrition Inst., 467 U.S. 340, 351 (quoting Data Processing Serv. v. Camp, 397 U.S. 150, 157 (1970)). Based upon the its analysis of the permissive nature of I.R.C. § 6404(e)(1), the Tenth Circuit concluded that "congressional intent to preclude judicial review is 'fairly discernible in the statutory scheme' of I.R.C. § 6404(e)." *Selman*, 941 F.2d at 1064.

146. *Selman*, 941 F.2d at 1064 (quoting H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 844 (1986); S. Rep. No. 99-313, 99th Cong., 2d Sess. 208 (1986)).

147. *Id.*

148. *Id.* The Eleventh Circuit reached a similar conclusion in 1991. Horton Holmes, Inc. v. United States, 936 F.2d 548 (11th Cir. 1991). *See supra* note 135.

149. 924 F.2d 967 (10th Cir. 1991).

lease and retains an interest in either production or proceeds of production, the interest of the assignor may take various forms. Generally, the retained interest will be structured as an overriding royalty. If the retained interest is a royalty, the assignment transaction will be treated as a sublease and payments made to the holder of the royalty will be taxed as ordinary income, subject to cost or percentage depletion.[150] If the retained interest is structured as a "production payment," however, the transaction will be treated as a sale, and income in respect of the production payment may be reported as capital gain.[151]

A production payment has been defined by the Supreme Court as "the right to a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced."[152]

If an interest is to be classified as a production payment, the right must have an expected useful life of shorter duration than the economic life of the burdened mineral property.[153] In other words, the life of the retained interest cannot be coextensive with the life of the burdened property. In this regard, the Fifth Circuit, in *United States v. Morgan*,[154] has stated the test as follows:

> (1) Could ordinarily prudent persons dealing in mineral lands or mineral leases, with knowledge of all facts then generally known or ascertainable, upon reasonable inquiry, pertaining to the lands and lease . . . involved, have reasonably expected, on

150. *See* I.R.C. §§ 613 and 613A (1988). The availability of percentage depletion to a particular mineral interest owner is subject to various definitional and mathematical limitations.

151. Whether a particular receipt constitutes ordinary income or capital gain had greater consequences prior to the enactment of the Tax Reform Act of 1986, which eliminated the income tax bracket differential between ordinary income and capital gains. However, that differential has been reinstated to a slight extent, *see id.* § 1(h), and proposals are continuously being presented in Congress to reinstate a more substantial income tax bracket differential between ordinary income and capital gains. See, e.g., § 2101 of H.R. 4210, the ill-fated Tax Fairness and Economic Growth Act of 1992, passed by both Houses of Congress on March 20, 1992, but immediately vetoed by President Bush. Moreover, the characterization of an item as capital gain or loss has continuing significance in the calculation of net capital gain or loss, *see id.* § 1222, and limitations on the deductibility of capital losses, *see id.* § 1211.

152. Anderson v. Helvering, 310 U.S. 404, 410 (1940).

153. Treas. Reg. § 1.636-3(a)(1) (1973) defines the term "production payment" as the following:

> [A] right to a specified share of the production from mineral in place, (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. *Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby.* A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of material, or a period of time. *A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property.*

(Emphasis added).

154. 321 F.2d 781 (5th Cir. 1963).

> or about [the date of the assignment] that the alleged oil payment then reserved by taxpayer upon the . . . assignment by him of the mineral lease . . . would be paid out before the expiration of the lease, and (2) did [taxpayer] then so expect?[155]

Addressing the first, or objective, prong of this test, the *Morgan* court noted:

> [The IRS] has acknowledged in private letter rulings that the possible classification of an oil payment as an overriding royalty because its life may be coextensive with the life of the property out of which it is payable can be successfully avoided by putting a "floor" on the oil payment which would make it impossible for the economic interest to extend over the life of the property. For example, if the assignment creating the oil payment provided that the interest would be extinguished when the estimated recoverable reserves were reduced to a specified amount, the term of the oil payment would not be coextensive with the life of the property. . . .[156]

These tax strategies were put to the test in *Yates*.

B. *Facts*

Yates had acquired three separate oil and gas leases of federal minerals through the federal noncompetitive lottery of oil and gas leases conducted by the Bureau of Land Management of the U.S. Department of Interior.[157] One of the leases, acquired in 1975, covered acreage in Golden Valley County, North Dakota, while the other two leases, acquired in 1977, covered acreage in Campbell County and Converse County, Wyoming.[158] Yates had paid a $10 filing fee and a $1 per acre annual delay rental for each lease. Yates assigned the Wyoming lease acreage in 1981, and the North Dakota lease acreage in 1982, to three separate corporations interested in exploring the acreage for oil.[159] Each of the three lease assignments reserved an "overriding royalty" to Yates that would terminate when 90% of the oil or gas had been produced.[160] In structuring the assignment, Yates and his advisor Mc-

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155. *Id.* at 786.

156. *Id.* at 787 n.3 (quoting CLARK W. BREEDING & A. GORDON BURTON, INCOME TAXATION OF OIL AND GAS PRODUCTION § 2.07 (1961)).

157. As required by 30 U.S.C. § 226(c) (1988), the lottery system leases were not within known geological structures of a producing oil or gas field.

158. Campbell and Converse Counties are located in the Powder River Basin, which attracted much drilling activity in the early 1980's.

159. For his $30 investment, and after paying annual delay rentals of approximately $3735 per year, Yates received $112,000 from Davis Oil Co. for the Converse lease, $309,147 from Lear Petroleum Exploration for the Campbell County lease, and $250,000 from Anadarko Production Co. for the Golden Valley lease. Yates v. Commissioner, 92 T.C. 1215, 1218 (1989).

160. The lease assignments designated the retained interests as overriding royalties; however, this fact does not control the classification of the retained interest for federal income tax purposes. *See* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1950); *Morgan*, 321 F.2d 781. Treas. Reg. § 1.636-3(a)(2) (1973) also provides in part that:

> A right which is in substance economically equivalent to a production payment shall be treated as a production payment . . . regardless of the language used to describe that right, the method of creation of such right, or the form in which

Caw[161] were apparently attempting to heed the advice cited in *Morgan*[162] by placing a "floor" on the payment which would make it impossible for the economic interest to extend over the entire life of the burdened property.

Taking the position that the income should be classified as a production payment, Yates reported the income paid to him by the lease assignees as capital gain.[163] The IRS took the position that the retained interest was an overriding royalty, and thus the payments received by Yates in 1981 and 1982 were advance payments on the royalties prior to production, taxable as ordinary income subject to depletion.[164] Yates filed a petition with the Tax Court, which sided with the IRS.[165] Yates appealed to the Tenth Circuit.

C. *The Tenth Circuit's Opinion*

On appeal, the Tenth Circuit[166] summarized the applicable Treasury Regulations as generally requiring that a "production payment" contain the following factors: (1) the income must derive from a right to a specific share of a production; (2) this right must have an expected economic life, at the time of its creation, of shorter duration than the economic life of the mineral property; (3) the right must be an economic interest in the mineral in place; (4) this right may only be satisfied by the production of the minerals; and (5) this right must be limited

> such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. . . .

The language in each of the three lease assignments was essentially identical, providing that:

> Assignor hereby excepts and reserves an overriding royalty of [varying percentages] of the proceeds received from the sale of all (8/8ths) of the oil and gas which may be produced . . . from said lands . . . *until such time as the then estimated recoverable reserves . . . are 10% or less whereupon said overriding royalty shall automatically terminate. . . .*

Yates v. Commissioner, 924 F.2d 967, 969 (10th Cir. 1991) (emphasis added). The percentages were: Converse County, 5%; Campbell County, 7.5%; and Golden Valley County, 6.25%. *Yates*, 92 T.C. at 1218.

161. Jack McCaw was a landman and was manager of the land department at Yates Petroleum Corp. *Yates*, 92 T.C. at 1217.

162. *See supra* text accompanying note 156.

163. The corporate assignors all deducted the payments as royalties. *Yates*, 92 T.C. at 1220.

164. The deficiencies were $131,475 for 1981 and $52,497 for 1982. *Id.* at 1216.

165. *Yates*, 92 T.C. 1215. Paraphrasing the *Morgan* test, the Tax Court analyzed the question by inquiring:

> [W]hether there was a reasonable prospect that the retained share of proceeds from the oil produced from any of the subject properties, up to the time that 90 percent of the recoverable reserves had been extracted, would in substance be paid out prior to the extraction of 100 percent of the recoverable reserves, and whether petitioners so expected.

Id. at 1226.

Based upon Yates's own evidence that the prospects of productivity were one chance in five, the Tax Court concluded that at the time of the assignments the likelihood of commercial production was small. *Id.* at 1229. The payments from the corporate assignees were thus held to be advances against an overriding royalty, taxable as ordinary income.

166. The three-judge panel was comprised of Judge Seymour, Judge Tacha and Judge Brorby.

by either a dollar amount and a quantum of mineral or by a period of time.[167] The parties and the court agreed that only the second of these requirements was at issue in this case.

As stated in the Treasury Regulations, the right "must have *an expected economic life* (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby."[168] The Tenth Circuit approved the standard applied by the Tax Court[169] and restated the standard in language employed by the Fifth Circuit in *Morgan*:

> [C]ould ordinarily prudent persons dealing in mineral lands or mineral leases, with knowledge of all facts than generally known or ascertainable upon reasonable inquiry pertaining to the lands and lease here involved, have reasonably expected on [the date of each lease assignment], that the alleged oil payment then reserved by taxpayer . . . would be paid out before the expiration of the lease, and . . . did [taxpayer] then so expect?[170]

There was little question that Yates had a subjective expectation that the lease acreage would be productive.[171] The Tenth Circuit thus turned to an examination of whether Yates had a reasonable objective expectation that the reserved oil payment be paid out before the expiration of the lease. If he did not, then the reserved interest would be viewed as running coextensively with the life of the underlying lease, and would thus be classifiable as a royalty.[172] Stated another way, there

167. Yates v. Commissioner, 924 F.2d 967, 970 (10th Cir. 1991). The definition is distilled from Anderson v. Helvering, 310 U.S. 404 (1940), and Thomas v. Perkins, 301 U.S. 655 (1937).

168. Treas. Reg. § 1.636-3(a)(1) (1973) (emphasis added).

169. *See supra* note 165.

170. *Yates*, 924 F.2d at 970-71 (quoting United States v. Morgan, 321 F.2d 781, 786 (5th Cir. 1963)).

171. As to the Campbell County acreage, McCaw was encouraged by the fact that Lear was obligated under the lease to drill a well within six months to a depth sufficient to test the Minnelusa formation, and had already drilled a producing well one-half mile from the lease property which was producing 400 barrels of oil per day. As to the Golden Valley County acreage, McCaw knew that Anadarko was drilling an offset well to a depth of 10,000 to 12,000 feet at a cost of approximately $1 million. Based on seismic data, he believed that the Golden Valley lease acreage was on the same oil field as this well, a belief reinforced by the significant retained interest Anadarko was willing to give to Yates on top of the large cash payment. Finally, McCaw believed that the Converse County lease acreage was located over an area with potentially five different productive zones, based on his study of maps, well completion cards and petroleum information bulletins. Yates v. Commissioner, 92 T.C. 1215, 1219-20 (1989).

172. *See Morgan*, 321 F.2d at 786. In *Morgan*, the taxpayer assigned an oil and gas lease for $71,400 and an oil payment of $10 million payable out of 1/16th of production. The lease was wildcat, the nearest production being two miles away. The district court granted the taxpayer's motion for summary judgment based on a literal reading of the *Anderson* test, *see supra* text accompanying note 152, and held the interest to be a production payment. The Fifth Circuit, noting that the tax laws deal with economic realities and not legal abstractions, fashioned the test quoted *supra* text accompanying note 155, and remanded. On remand, the district court concluded that it was "not reasonable [on the date of assignment] that anyone could have reasonably expected the sum of $10,000,000 to be paid before the expiration of the lease" and held the payment to be an advance against an overriding royalty. Morgan v. United Sates, 245 F. Supp. 388, 390 (S.D. Miss. 1964).

cannot be an objective expectation that the oil payment will be paid out prior to the expiration of the lease unless there is also an objective expectation that the lease will *have* production from which payment can be made. The question thus became whether Yates's retained interest possessed "an expected economic life." In the view of the Tenth Circuit, the word "expected"

> [n]either notes nor means a mere possibility of production. Some reasonable degree of certainty, but less than absolute, is thus required. The regulations requires this expectation to exist and be measured at the time of its creation which, in the instant case, would mean at the time each lease was assigned as this was the time when the overriding royalty was created.[173]

The expert witnesses for the IRS had testified that the chances of obtaining production from the leases were anywhere from 1 out of 25 to 1 out of 120.[174] Yates had pointed to the fact that there were productive wells in the vicinity of the lease acreage Yates had assigned. However, the Tenth Circuit found that Yates had been able to identify only one productive well in the vicinity of each of the leases, whereas there were many dry holes in the same vicinity. The Tenth Circuit noted that many factors, other than the mere existence of a producing well in the vicinity, are to be taken into account in determining the probability of obtaining production from particular lease acreage.

> Relevant circumstances would include numerous factors such as available geological and seismic information; the cost of lease acquisition; the costs of exploring, drilling and producing; the price of oil and the price of its treatment and transportation costs; the probable pay-out; the prices received by the taxpayer; the proximity of production as well as many other factors. It would be a rare case if any one or two of these factors were alone controlling.[175]

Considering all the evidence, the Tenth Circuit agreed that the objective prong of the *Morgan* test had not been satisfied, and the payments to Yates were properly characterized as advances on an overriding royalty, taxable as ordinary income.

The Tenth Circuit conceded that "a taxpayer who attempts to create a 'production payment' from nondeveloped property bears a difficult burden of persuasion."[176] The court noted, however, that "it is not an impossible burden. The significant issue remains the same, *i.e.*, whether there exists a reasonable likelihood of production on the lease assigned as of the date the production payment is being reserved."[177] The fact that Yates subjectively believed that there was a slight possibility of production was not enough to carry his burden of proof, since some reason-

173. *Yates*, 924 F.2d at 970.

174. *Id.* at 971. Under the evidence most favorable to Yates, the prospects of productivity were 1 out of 5, a figure accepted by the Tax Court. *Yates*, 92 T.C. at 1229. Such findings of fact are not to be set aside unless clearly erroneous. *See supra* note 87.

175. *Yates*, 924 F.2d at 971-72.

176. *Id.* at 972.

177. *Id.*

able degree of certainty is required to satisfy the objective prong of the *Morgan* test. "Oil and gas developers are 'world class' optimists and the fact they may regard a slight chance of production being obtained as a 'reasonable expectation' does not make it so."[178]

D. *Summary*

Given the relatively insubstantial difference in income tax brackets applicable to ordinary income and capital gains under current law, classification of a retained interest as an overriding royalty or a production payment would not seem to have much current urgency. However, if an income tax bracket differential is reinstated in the future, *Yates* provides essential guidance for taxpayers concerning the standards the Tenth Circuit will apply—and the burden that will be imposed—in determining whether a particular retained interest is a "production payment." Although the Tenth Circuit did not adopt a *per se* rule that no production payment can ever be created out of nonproducing property,[179] a taxpayer's burden will be particularly high when the retained interest relates to undeveloped or unproven property.

VIII. Property Does Not "Pass" to Surviving Spouse for Purposes of the Marital Deduction When Surviving Spouse Surrenders her Survivorship Rights in Settlement of Dispute Over Estate: *Schroeder v. United States*[180]

A. *Background*

The federal estate tax is imposed upon the value of every decedent's taxable estate.[181] The phrase "taxable estate" is defined as the value of the decedent's "gross estate"[182] less certain deductions[183] allowed under the Code. From an estate tax planning standpoint, the marital deduction provided under I.R.C. § 2056 is the most important. Under I.R.C. § 2056, "the value of the taxable estate shall . . . be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property *which passes or has passed* from the decedent to his surviving spouse."[184] The marital deduction will be available only if the property claimed to give rise to the marital deduction is considered to have "passed" from the decedent to the surviving spouse.

As to property held jointly between a decedent and a surviving

178. *Id.*

179. *Id.*

180. 924 F.2d 1547 (10th Cir. 1991).

181. I.R.C. § 2001 (1988).

182. The value of the "gross estate" is determined by including the value of all the decedent's property, real or personal, tangible or intangible, wherever situated, at the time of his death. *Id.* § 2031(a). A series of important evaluation and inclusion rules are set forth in *id.* §§ 2032 to 2046.

183. *Id.* §§ 2053 to 2056A.

184. *Id.* § 2056(a) (emphasis added).

spouse, the Code specifically provides that an "interest in property shall be considered as passing from the decedent to any person if . . . such interest was, at the time of the decedent's death, held by such person and the decedent . . . in joint ownership with right of survivorship."[185] In *Schroeder*, a case of first impression in the federal estate tax area, the Tenth Circuit was faced with the question whether property "passed" from a decedent to his surviving spouse when the property had been held in joint tenancy by the decedent and the surviving spouse, but the surviving spouse had surrendered her survivorship rights to the property in settlement of a dispute with the decedent's daughters from a previous marriage.

B. *Facts*

Thomas and Peggy Woodmansee were married for approximately eighteen years. Thomas had two adult daughters from a previous marriage, Martha Schroeder and Lou Ann Waters. Unbeknownst to Schroeder and Waters, Thomas created a substantial stock account with Merrill Lynch in early July 1981, naming himself and Peggy as joint tenants with a right of survivorship. Ten days later, Thomas executed a will providing that his property be placed in trust, the income from which was to be used to provide for Peggy during the remainder of her life, with the corpus of the trust to be divided equally between Schroeder and Waters at Peggy's death. Both Schroeder and Waters executed an affidavit stating that they knew of the provisions of the will and of their father's intent, and that both intended to honor their father's wishes. Two months later, when the fair market value of the stock account was approximately $229,843, Thomas died.

Pursuant to Peggy's survivorship rights in the stock account, the account passed directly to Peggy at Thomas's death and did not pass through Thomas's will.[186] Schroeder and Waters, however, felt that

185. *Id.* § 2056(c)(5) (1988).

186. Although the property represented by the joint stock account did not pass to Peggy pursuant to the terms of Thomas's will, under I.R.C. § 2040(a), the value of Thomas's interest in the stock account would have been includable in determining his gross estate. It should also be noted that the amount of a decedent's interest in jointly-held property that is includable in the gross estate is not necessarily equal to his "interest" in that property. The amount included is measured by the owners' relative monetary contributions to the property. For example, the fact that A and B each own a one-half interest in Blackacre as joint tenants does not mean that one-half the value of Blackacre will be includable in A's gross estate upon her death. If A had paid for Blackacre, the entire value of Blackacre would be includable in her gross estate. Conversely, if B had provided all the consideration in purchasing Blackacre, A would include nothing. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.12[4] (6th ed. 1991).

Presumably, however, only one-half of the stock account was includible in Thomas's gross estate, under the "qualified joint interest" rules of I.R.C. § 2040(b). At the time of Thomas's death, these rules provided that only one-half of a qualified joint interest is includible, and defined the term "qualified joint interest" to mean any interest in property held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if (a) the joint interest was created by the decedent, the decedent's spouse, or both; (b) in the case of personal property, the creation of the joint interest constituted a gift in whole or in part; and (c) in the case of a joint tenancy, only the decedent and the decedent's spouse are joint tenants. As a result of the enactment of the Economic Recov-

Peggy had a "moral duty" to leave the principal of the stock account to them and their children, consistent with the estate plan reflected in the dispositive provisions of Thomas's will.

In February 1982, Peggy placed the stock account into a trust having a neutral trustee to "maintain the peace and keep from being sued."[187] One-fourth of the quarterly income from the trust was to be distributed to Peggy, three-eighths to Schroeder, and three-eighths to Waters. At Peggy's death, the principal in the trust account was to be distributed in equal shares to Schroeder and Waters or their issue.

Thomas's interest in the joint stock account was included in the gross estate on the estate tax return, and was also claimed as part of the federal marital deduction under I.R.C. § 2056.[188] The IRS disallowed the portion of the marital deduction which was based upon the stock account. The estate paid the deficiency and unsuccessfully claimed a refund. Schroeder's husband, the executor of the estate, commenced a refund suit in district court, which proved to be unsuccessful.[189] On appeal, the Tenth Circuit affirmed.

C. *The Tenth Circuit's Opinion*

The question before the Tenth Circuit[190] on appeal was whether Thomas's interest in the joint stock account "passed" to Peggy within the scope of I.R.C. § 2056, so that the property qualified for the marital deduction. The estate's position, of course, was that the property did "pass" to Peggy, since the stock account was held in joint ownership with right of survivorship at Thomas's death.[191] If the position of the estate were accepted, the principal of the joint stock account would have passed to Thomas's daughters without the imposition of an estate tax at the parental level.

This result is inconsistent with the legislative purpose of the marital deduction, which is to allow property to pass without the imposition of an estate tax within the marital unit when one spouse dies. Absent the existence of the marital deduction, an estate tax would be imposed on

ery Tax Act of 1981, a qualified joint interest is now defined as any interest in property held by the decedent and the decedent's spouse as (a) tenants by the entirety, or (b) joint tenants with right of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants. I.R.C. § 2040(b)(2) (1988). The qualified joint interest rules are designed to sidestep the obvious difficulties inherent in determining the relative monetary contributions that each spouse makes to marital property.

187. Schroeder v. United States, 696 F. Supp. 1426, 1428 (W.D. Okla. 1988).

188. Thomas died September 17, 1981. At that time, I.R.C. § 2056(c)(1)(A) limited the marital deduction to the greater of $250,000, or 50% of the value of the gross estate (calculated with certain adjustments). The Economic Recovery Tax Act of 1981 repealed I.R.C. § 2056(c), and for estates of decedents dying after December 31, 1981, the marital deduction is unlimited as to property passing to the surviving spouse in a manner otherwise qualifying for the deduction.

189. *Schroeder*, 696 F.Supp. 1426.

190. The three-judge panel was comprised of Chief Judge McKay, Judge Seymour, and Judge John L. Kane, United States District Court for the District of Colorado, sitting by designation.

191. *See supra* text accompanying note 185.

the gross estate of the first spouse to die, and imposed again when their surviving spouse dies, leaving the property to the children of the marital unit. The children would receive the property only after an estate tax had been imposed twice at the parental level.

The pre-1982 marital deduction provided a partial solution to this problem and paid some deference to the notion that transfers between spouses, being transfers within a single marital unit, should not be taxed, or at least should not be fully taxed. As part of the "family orientation" of the Economic Recovery Tax Act of 1981, the marital deduction became unlimited, giving full effect to the notion that transfers between spouses in the marital unit should not be taxed.[192] The legislative history accompanying the Economic Recovery Tax Act of 1981 provides that:

> Because the maximum estate tax marital deduction generally is limited, under present law, to one-half of a decedents' adjusted gross estate, the estate of a decedent who bequeaths his entire estate to his surviving spouse may be subject to estate taxes even though the property remains within the marital unit. When the surviving spouse later transfers the property (often to their children), the entire amount is subject to transfer taxes. The cumulative effect is to subject their property to tax one and one-half times, *i.e.*, one-half upon the death of the first spouse, and again fully upon the death of the second spouse. This effect typically occurs in the case of jointly held property. Because this additional tax falls most heavily on widows, it is often referred to as the "widow's tax."
>
> Although the committee recognizes that this additional tax can be minimized through proper estate planning, it believes that an individual should be free to pass his entire estate to a surviving spouse without the imposition of any additional tax . . . .[193]

The legislative history of the marital deduction clearly evinces an understanding that the estate tax will be imposed upon the ultimate transfer of the property to the next generation, although no estate tax is to be imposed upon transfers between members of the marital unit. If Thomas's estate plan had been structured so that his interest in the joint stock account passed instead to the testamentary trust[194] or directly to Thomas's daughters, no marital deduction would be allowable. The estate was in effect arguing that it could do indirectly what could not be done directly, that is, pass property from the marital unit to the next generation without the imposition of an estate tax.[195]

192. "[A] husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes. Accordingly, no tax should be imposed on transfers between a husband and wife." S. REP. No. 97-144, 97th Cong., 1st Sess. 126 (1981), *reprinted in* 1981 U.S.C.C.A.N 105, 228.

193. H.R. REP. No. 97-201, 97th Cong., 1st Sess. 158-64 (1981).

194. Subject to the possibility of structuring the arrangement as a "qualified terminable interest property" trust, or "QTIP trust." I.R.C. § 2056(b)(7) (1988).

195. Peggy did not report the transfer of the stock account into the new trust on a gift

Before addressing whether the property "passed" to Peggy, the Tenth Circuit first considered the IRS's primary contention that the matter was controlled by the "will contest regulation," which provides that:

> (1) If, as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having "passed from the decedent to his surviving spouse."
>
> (2) If, as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interest depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.[196]

The Tenth Circuit pointed out that the will contest regulation is consistent with the legislative history of I.R.C. § 2056, which provides:

> If the surviving spouse takes under the decedent's will, the interest passing to her is determined from the will. In this connection proper regard should be given to interpretations of the will rendered by a court in a bona fide adversary proceeding. If, as a result of a controversy involving a bequest or devise to the surviving spouse, such spouse assigns or surrenders an interest in property pursuant to a compromise agreement in settlement of such controversy the amount so assigned or surrendered is not deductible as an interest passing to such spouse.[197]

The Tenth Circuit found that the will contest regulation, when read together with the legislative history, reflected at least two aspects that seemed to be absent under the facts in *Schroeder*. First, the regulations and the legislative history can be fairly read to implicitly require that the "will contest" or "controversy" arise in some sort of formal adversarial

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tax return, nor did she report the transfer as a sale of the account on her income tax return.

196. Treas. Reg. § 20.2056(e)-2(d) (1958).

197. S. REP. No. 1013, 80th Cong., 2d Sess. 4 (1948), *reprinted in* 1948 U.S.C.C.A.N. 1163, 1226.

proceeding, involving litigation and a judicial determination of the parties' rights, or at least a settlement of such litigation. Second, the will controversy must be one "involving the decedent's will, or involving any bequest or devise thereunder."

The IRS relied heavily upon cases which had expansively applied the will contest regulation to disallow claimed marital deductions. In *Citizens & Southern National Bank v. United States*,[198] the decedent had died intestate owning property in Florida and in Georgia. After the decedent's death, his wife and his son from a previous marriage entered into an agreement under which she received $40,000 from the son in exchange for her statutory interest in the Georgia and Florida properties. Relying upon the will contest regulation, the Fifth Circuit affirmed the IRS's disallowance of the marital deduction based on the value of the Florida and Georgia properties, and limited the deduction to the $40,000 actually received by the surviving spouse.

The Fifth Circuit had relied upon the Second Circuit's broad interpretation of the will contest regulation in *United States Trust Co. v. Commissioner*.[199] In that case, the decedent intended to give his wife a life estate with a power of appointment over a portion of his New York estate and to have his wife inherit his villa in France. The latter disposition was blocked by a French requirement that his daughters execute certain documents, which they refused to do. After negotiations, the daughters agreed to execute the appropriate documents in exchange for the wife's agreement to relinquish her power of appointment over the decedent's New York property. The Second Circuit concluded that the wife could not claim her marital deduction for the value of the New York property, holding that the marital deduction was to be taken only for the property which the wife actually received after the terms of the settlement agreement had been fulfilled, *i.e.*, the French property, which did not qualify for the marital deduction. The Second Circuit stated that "[w]hen the resolution of a controversy between the beneficiaries regarding the decedent's property culminates in an agreement by which the surviving spouse relinquishes property which qualifies for the marital deduction in return for property which does not so qualify, [the will contest regulation] is applicable."[200]

The Tenth Circuit strongly indicated that it would not follow either *United States Trust Co.* or *Citizens & Southern* if faced with similar facts. The court first pointed out that both the Second and Fifth Circuits had interpreted the phrase "contest" as used in the will contest regulation to include mere arms-length negotiations among beneficiaries. In the Tenth Circuit's view, this is not enough to trigger application of the will contest regulation.[201] The court likewise criticized the approach of *Citizens &*

198. 451 F.2d 221 (5th Cir. 1971).

199. 321 F.2d 908 (2d Cir. 1963).

200. *Id.* at 910-11.

201. The court described *United States Trust Co.* and *Citizens & Southern* as having expanded the reach of the will contest regulation "well beyond its plain language. . . . to included arms-length negotiations conducted between parties who have *potentially* adverse

Southern in interpreting "the decedent's will, or involving any bequest or devise thereunder" to "include transfers of property at death under intestacy statutes or spousal election."[202] The court declined to adopt such as expansive interpretation when the property did not pass under Thomas's will, or involve a bequest or devise under the will, but was instead transferred pursuant to Peggy's right of survivorship.

> Peggy's rights in the present case to . . . the joint account do not arise under Thomas' will. It is undisputed that Peggy surrendered this property in settlement not of a will contest, but of a more general controversy over the rightful passing of Thomas' property considered as a whole. By its plain terms, therefore, the will contest regulation is not dispositive here.[203]

The Tenth Circuit then turned to the key question under I.R.C. § 2056: whether the stock account "passed" from the decedent to Peggy. The court recognized that transfers of property by survivorship rights concerning joint interests "passed" within the meaning of the Code's marital deduction provision. Nevertheless, the court stated that the stock account property did not "pass" to Peggy. Borrowing from the reasoning of *United States Trust Co.* and *Citizens & Southern*, the court construed the statutory "passing" requirement to mean "property to which the surviving spouse *retains* her rights after resolution of all disputes concerning the decedent's property,"[204] regardless of the medium by which the property passes.

> [W]e find the reasons those courts articulated to broaden the reach of the regulation to be persuasive in our own analysis of what Congress intended by the "passing" requirement in the marital deduction statute. To the extent a surviving spouse surrenders her share of the decedent's property to other beneficiaries not entitled to the marital deduction to avoid litigation concerning her rights, it defies common sense to conclude that this property "passed" to the surviving spouse.[205]

As support for its conclusion, the Tenth Circuit reiterated the congressional purpose behind the marital deduction:

> The marital deduction was designed to eliminate the "double-taxation" that would result when the same property became subject to tax upon the death of each spouse. Once property passes outside of the interspousal unit, however, this exception no longer applies. Under Schroeder's proposed interpretation, property may exit the spousal unit without *ever* creating a taxable event. Congress clearly did not intend to replace double-taxation with tax avoidance.[206]

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positions. Under this view, no litigation is required, much less court adjudication of various parties' rights to the property of the deceased." Schroeder v. United States, 924 F.2d 1547, 1553 (10th Cir. 1991) (emphasis added).

202. *Id.*

203. *Id.*

204. *Id.* at 1553-54 (quoting Citizens & Southern Nat'l Bank v. United States, 451 F.2d 221, 227 (5th Cir. 1971) (emphasis added)).

205. *Id.* at 1554.

206. *Id.* at 1555.

Peggy did not retain any rights in the stock account after resolution of the dispute, and the legislative purpose of the marital deduction would be frustrated if the estate could claim a marital deduction with respect to Thomas's interest in the account. The Tenth Circuit thus held that no marital deduction was allowable for the value of Thomas's interest in the account at his death.

D. *Summary*

As noted, *Schroeder* is a case of first impression not only in the Tenth Circuit, but in the general area of federal estate taxation. The Tenth Circuit's conclusion that the stock account did not "pass" to Peggy within the meaning of I.R.C. § 2056, despite the nonapplicability of the will contest regulation, rests squarely on firm policy grounds. If a contrary view were taken, beneficiaries could stage friendly "controversies" with the goal of claiming a martial deduction for property that comes to rest outside the marital unit in the next generation.

The Tenth Circuit's unwillingness to expansively apply the will contest regulation may also indicate a more general philosophy that the Treasury Regulations should be construed narrowly, and invoked only when the language of the Regulations is by its terms expressly relevant. When interpreting and applying the broader provisions of the Code itself, however, the Tenth Circuit seems perfectly willing to invoke legitimate policy concerns to reach proper results.

Schroeder did not resolve the proper treatment of property that a surviving spouse *receives* from others in return for her relinquishment of rights in the property otherwise qualifying for the deduction. The will contest regulation again would appear to be inapplicable, because there would be no true "will controversy," and because the controversy would not involve the decedent's will or bequests or devises thereunder. Under the analysis of *United States Trust Co.* and *Citizens & Southern*, however, which focuses on the state of affairs as they exist after all disputes have been resolved, the property received by the surviving spouse in exchange for relinquishing rights in jointly-held property should qualify for the marital deduction, just as the $40,000 payment qualified in *Citizens & Southern*.

IX. Judgment Creditor's Choate Lien in After-Acquired Property Primes Later-Perfected Federal Tax Lien: *McDermott v. Zions First National Bank*[207]

A. *Background*

The Code grants a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to any person liable to pay any tax who neglects or refuses to pay the same

207. 945 F.2d 1475 (10th Cir. 1991).

after demand.[208] The general rule under the Code is that the general federal tax lien arises at the time the assessment is made[209] and continues until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time.[210]

The priority afforded competing federal tax liens and state-created liens is a matter of federal law.[211] Secured creditors will generally have priority over the federal tax lien if their state-created liens were fully perfected and choate before the federal tax lien arose at the time of assessment.[212] Judgment lien creditors, however, are afforded special treatment under the Code. The Code provides that the general federal tax lien is not valid against any judgment lien creditor until notice thereof has been filed by the IRS.[213] *McDermott* was an interpleader action centering on the competing claims of a judgment lien creditor and the IRS in real property located in Salt Lake County, Utah.

B. *Facts*

Zions First National Bank ("Zions") had obtained a judgment in the amount of $67,977.67 against the McDermotts on June 22, 1987. Zions properly docketed the judgment in Salt Lake County on July 6, 1987. Under Utah law, Zions's lien attached to all of the McDermotts' real property located in the county.[214] The IRS obtained its lien by filing a Notice of Federal Tax Lien on September 9, 1987. As a result of this filing, the IRS's lien attached to all the McDermotts's owned and after-acquired real and personal property.[215]

On September 23, 1987, the McDermotts acquired title to real

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208. I.R.C. § 6321 (1988). The lien secures the amount of the deficiency, plus any interest, additional amount, addition to tax, assessable penalty and costs.

209. Assessments are little more than bookkeeping notations entered by the IRS on the taxpayer's account indicating that the amount has been administratively determined to be due and payable.

210. I.R.C. § 6322 (1988).

211. United States v. Equitable Life Assurance Soc'y of the U.S., 384 U.S. 323, 328 (1966); Allan v. Diamond T Motor Car Co., 291 F.2d 115, 116 (10th Cir. 1961). The general federal tax lien " 'creates no property rights but merely attaches consequences, federally defined, to rights created under state law.' " Avco Delta Corp. of Can. Ltd. v. United States, 459 F.2d 436, 440 (7th Cir. 1972) (quoting United States v. Bess, 357 U.S. 51, 55 (1958)).

212. United States v. City of New Britain, 347 U.S. 81 (1954).

213. I.R.C. § 6323(a) (1988). In Colorado, such notice is deemed to have been provided by the IRS (a) with respect to real property, upon the filing of a Notice of Tax Lien with the Office of the Clerk and Recorder for the county in which the real property is located; and (b) as to personal property, upon the filing of a Notice of Tax Lien with the Colorado Secretary of State. COLO. REV. STAT. § 38-25-102 (Supp. 1990).

214. Utah law provides:

> From the time the judgment of the District Court or Circuit Court is docketed and filed in the Office of the Clerk of the District Court of the County it becomes a lien upon all the real property of the judgment debtor, not exempt from execution, in the county in which the judgment is entered, owned by him at the time *or by him thereafter acquired* during the existence of said lien.

UTAH CODE ANN. § 78-22-1 (1992) (emphasis added).

215. Even though not specifically stated in I.R.C. § 6321, the general federal tax lien applies to after-acquired property. Glass City Bank v. United States, 326 U.S. 265 (1945).

property in Salt Lake County.[216] The McDermotts already had a purchaser for this property. However, in order to obtain title insurance for the property to complete the sale, the McDermotts were required to obtain releases from Zions and the IRS. The parties entered into an escrow agreement under which Zions and the IRS released their claims to the Salt Lake County property, but reserved their rights to the cash proceeds of the sale. The escrow agreement provided that the priority of the competing claims of Zions and the IRS would remain identical to the priorities they held in the Salt Lake County property.[217] The escrow agreement also called for the McDermotts to institute an interpleader action so that a court could determine who was entitled to priority in the proceeds of the sale.

In the district court,[218] the IRS argued that its lien should have priority over the lien held by Zions because the latter was not "choate" when the IRS filed its Notice of Tax Lien since the McDermotts did not yet own the property. The district court sided with Zions in an unreported decision, and the IRS appealed.

C. *The Tenth Circuit's Opinion*

The issue before the Tenth Circuit[219] was whether Zions's non-contingent, or choate, lien on all of the McDermott's real property, perfected prior to the federal tax lien, took priority over the federal lien when the competing lienors were each claiming an interest in after-acquired property. As noted above, judgment lien creditors are among the creditors who have priority over federal tax liens when their liens are fully perfected and "choate" prior to the filing of the federal government's Notice of Tax Lien. "The doctrine of choateness is intended to protect the standing of federal liens. 'Otherwise, a State could affect the standing of federal liens, contrary to the established doctrine, simply by causing an inchoate lien to attach at some arbitrary time. . . .' "[220]

216. The McDermotts had originally sold this property to two individuals in 1981, taking back a note and a deed of trust which secured the note with the purchasers' interest in the property, such interest being conveyed to the public trustee. The purchasers defaulted and, after some interim struggles and maneuvers, the McDermotts succeeded in getting the trustee to notice a sale of the property, at which the McDermotts repurchased the property by submitting a credit bid and assuming an underlying mortgage. McDermott v. Zions First Nat'l Bank, 945 F.2d 1475, 1477-78 (10th Cir. 1991).

217. The escrow agreement provided, in relevant part:

> The respective priorities of the parties to the cash proceeds shall be identical to the priorities of the respective liens of the parties as they existed against the real property as of September 23, 1987, after Bruce J. McDermott successfully bid and purchased the property at the Trustee's Sale, notwithstanding the change in form of the collateral.

Id. at 1477.

218. The interpleader action was originally brought by the McDermotts in state court, but the United States removed the case to federal court pursuant to 28 U.S.C. § 1442(a)(1) (1988).

219. The three-judge panel consisted of Judge Tacha, Judge Seth and Judge Howard C. Bratton, United States District Court for the District of New Mexico, sitting by designation.

220. McAllen State Bank v. Sacenz, 561 F.Supp. 636, 639 (S.D. Tex. 1982) (quoting United States v. City of New Britain, 347 U.S. 81, 86 (1954)).

Whether a lien is choate is a federal question.[221] For a prior lien on all of a person's real or personal property to take priority over a federal tax lien, the lien must be "perfected in the sense that there is nothing more to be done to have a choate lien—when the identity of the lienor, the property subject to the lien, and the amount of the lien are established."[222]

The Treasury Regulations acknowledge the judicially-created choateness doctrine in defining the term "judgment lien creditor" for purposes of the Code.[223] The position of the IRS on appeal in *McDermott* was that the "property subject to the lien" had not been established as required by this definition, and that the lien was therefore not choate. Because the choateness doctrine requires that the property subject to the lien be established, the IRS argued, a judgment lien creditor can only acquire a perfected or choate lien with respect to property owned by the debtor at the time the judgment creditor obtains his lien. Therefore, after-acquired property of the debtor would be subject to a superior federal tax lien if that lien was perfected by filing after the judgment lien creditor obtained his lien, but before the debtor obtained ownership of the property to which the competing liens attach. Since Zions's judgment lien did not become choate until September 23, 1987, when the McDermotts acquired title to the real property in question, the IRS's lien, as perfected by its Notice of Federal Tax Lien filed on September 9, 1987, would take priority. The Tenth Circuit rejected the IRS's position, holding that a judgment lien creditor having a choate lien on *all* of a person's real property will take priority over a later-perfected federal tax lien, even when the IRS and the judgment creditor are claiming after-acquired property.

In support of its decision, the Tenth Circuit relied primarily on *United States v. Vermont*.[224] In *Vermont*, the State of Vermont and the United States held almost identical general tax liens upon all the taxpayer's real and personal property. Vermont's lien arose approximately

221. United States v. Security Trust & Sav. Bank, 340 U.S. 47, 49-50 (1950).

222. *City of New Britain*, 347 U.S. at 84.

223. The definition states that:

> The term "judgment lien creditor" means a person who has obtained a valid judgment, in a court of record and of competent jurisdiction, for the recovery of specifically designated property or for a certain sum of money. In the case of a judgment for the recovery of a certain sum of money, a judgment lien creditor is a person who has perfected a lien under the judgment on the property involved. *A judgment lien is not perfected until the identity of the lienor, the property subject to the lien, and the amount of the lien are established.* Accordingly, a judgment lien does not include an attachment or garnishment lien until the lien has ripened into judgment, even though under local law the lien of the judgment relates back to an earlier date. If recording or docketing is necessary under local law before a judgment becomes effective against third parties acquiring liens on real property, a judgment lien under such local law is not perfected with respect to real property until the time of such recordation or docketing. If under local law levy or seizure is necessary before a judgment lien becomes effective against third parties acquiring liens on personal property, then a judgment lien under such local law is not perfected until levy or seizure of the personal property involved. . . .

Treas. Reg. § 301.6323(h)-1(g) (1976) (emphasis added).

224. 377 U.S. 351 (1964).

three and one-half months prior to the federal tax lien. As in *McDermott*, the United States argued that a state-created lien had to attach to specific property in order for it to take priority. The Supreme Court held that both liens were equally perfected as to all the taxpayer's property and were choate at the time the liens arose.[225] Therefore, when both governments attempted to satisfy their liens with the same after-acquired property, Vermont's lien took priority since it arose first.[226]

The Tenth Circuit concluded that Zions's lien was no less choate than was Vermont's in *United States v. Vermont*. Zions's lien "was not contingent, it was docketed, specific in amount, and fully enforceable against any real property owned by the McDermotts in Salt Lake County during the pendency of the lien."[227] The Tenth Circuit thus concluded that "judgment lien creditors who perfect their liens before the filing a federal tax lien have priority,"[228] even where the property against which the competing liens are asserted is after-acquired property.

D. *Summary*

McDermott should allay any fears of judgment lien creditors about the priority of their liens over competing federal tax liens with respect to after-acquired property. If the judgment lien creditor's lien becomes choate prior to the filing of notice of the federal tax lien under the choateness doctrine, as reflected in the Treasury Regulations and as interpreted by the courts, the federal lien will not prime the judgment lien.

X. NO DEDUCTION FOR INTEREST ATTRIBUTABLE TO NONRECOURSE DEBT LACKING ECONOMIC SUBSTANCE: *AMES V. COMMISSIONER*[229]

A. *Background*

The Code generally allows taxpayers to deduct "all interest paid or accrued within the taxable year on indebtedness."[230] However, for such

225. *Id.* at 358-59.
226. *Id.* at 354, 359.
227. McDermott v. Zions First Nat'l Bank, 945 F.2d 1475, 1481 (10th Cir. 1991).
228. *Id.*
229. In an unpublished Order and Judgment ("the Order"), 937 F.2d 616 (10th Cir. 1991), the Tenth Circuit affirmed the Tax Court's decision in Ames v. Commissioner, 58 T.C.M. (CCH) 1470 (1990). The Order is reprinted at 91-2 U.S. Tax Cas. (CCH) ¶ 50,363. The Order has no precedential value and may not be cited or used by any court within the Tenth Circuit, except for purposes of establishing the doctrines of law of the case, res judicata, or collateral estoppel. 10TH CIR. R. 36.3.
230. I.R.C. § 163 (1988). The taxable year at issue in *Ames* was 1981. Subsequently, I.R.C. § 163 was substantially amended, particularly by the Tax Reform Act of 1986. Today, the deductibility of interest generally turns on the classification of that interest as either "investment interest" (generally deductible only to the extent of net investment income, *see id.* § 163(d)); "qualified residence interest" (consisting of either acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer, subject to various definitional and other limitations, *see id.* § 163(h)(3)); interest paid or accrued on indebtedness allocable to a trade or business (generally, fully deductible); or "personal interest" (generally all types of consumer interest other than the foregoing, fully nondeductible for 1991 and later tax years, *see id.* § 163(h)).

interest to be deductible, there must be a valid and legitimate "indebtedness" in respect to which the interest is payable.[231] Special considerations arise when the debt is nonrecourse and the secured lender may only look to the encumbered property in the event of default. Courts will generally not view nonrecourse debt as legitimate if the amount of the obligation bears no reasonable relationship to the value of the property securing the payment of the debt. Where the amount of the indebtedness far exceeds the fair market value of the property securing the debt, the borrower/taxpayer will be considered as having no economic incentive to meet the debt service payments because the taxpayer will never obtain any equity in the property. All other things being equal, the taxpayer will be viewed as having no other incentive but to simply abandon the property to the secured lender. Since the indebtedness is unlikely to be repaid in these circumstances, it will not ordinarily be recognized for tax purposes.[232]

B. *Facts*

Henry Ames was one of several taxpayers who participated in a tax shelter arrangement involving fifty-two vacation homes in the Park City, Utah, area. In 1980, Ames[233] purchased a timeshare unit in one of these vacation homes, which gave him the right to occupy the home for one day each year. The purchase price was $2775, of which Ames paid $650 down, leaving an unpaid principal of $2125. The sales contract with the seller of the vacation homes[234] called for interest to be paid on the $2125 at the rate of 188% ($3995) per year for the first fourteen years, and 47% ($998.75) per year for the remaining sixteen years. Ames agreed to pay $465 per year for the first ten years to be applied to interest. No further principal or interest payments were required until thirty years from the purchase date, when a balloon payment of principal and accrued but unpaid interest equal to $69,475 would be due and payable. At that time, because the debt was nonrecourse, Ames was effectively faced with the choice of either forfeiting his interest in the timeshare unit to his lender, or making the balloon payment of $69,475 and becoming the owner of the timeshare unit.

231. *See, e.g.*, Knetsch v. United States, 364 U.S. 81 (1960); Durkin v. Commissioner, 872 F.2d 1271 (7th Cir.), *cert. denied*, 493 U.S. 824 (1989); Norton v. Commissioner, 474 F.2d 608 (9th Cir. 1973); Narver v. Commissioner, 75 T.C. 53, *aff'd without published opinion*, 670 F.2d 855, (9th Cir. 1982).

232. *See, e.g.*, Lebowitz v. Commissioner, 917 F.2d 1314 (2d Cir. 1990); Odend'hal v. Commissioner, 748 F.2d 908 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985); Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). In addition, highly contingent or speculative obligations, recourse or nonrecourse, are not recognized for federal income tax purposes. Fox v. Commissioner, 731 F.2d 230 (4th Cir. 1984); Brountas v. Commissioner, 73 T.C. 491 (1979).

233. In actuality, the husband-and-wife taxpayers formed a partnership, "Ames and Ames," to avoid Utah usury law. The partnership then elected to utilize the accrual method of accounting.

234. Kilburn Vacation Home Shares, Inc. owned the vacation homes. Kilburn had converted the homes to time shares, dividing each home into 350 days and reserving the remaining 15 days for maintenance and cleaning. The timeshare units were then marketed though a dealer, Affiliated Development Corp., and by secondary dealers.

In 1980 and 1981, the taxpayers claimed a deduction for interest in the amount of $3995.[235] The Tax Court upheld the Commissioner's disallowance of the interest deductions, finding that the investment in the timeshare units did not constitute genuine indebtedness.[236] The taxpayers appealed.[237]

C. *The Tenth Circuit's Order*

At the Tax Court level, the taxpayers had theorized that the timeshare unit would appreciate from 12.7% to 23% per year during the life of the purchase contract, due to inflation and other factors. It was therefore contended that the purchase was a sound business investment, and that the property would have a fair market value at all times equal to the amount of the payoff figure for the loan. The Tax Court, while in no way accepting these projections, had concluded that the opposite was true. Due to the fact that the interest rate was front-loaded at 188% for the first fourteen years, and then accrued at the rate of 47% per year for the final sixteen years, the payoff figure for the indebtedness would always be much higher than the fair market value.[238]

The Tenth Circuit[239] concluded that the "record well supports this conclusion"[240] and accepted the findings of the Tax Court.[241] It

235. This represented an approximate write-off ratio of 8.6:1 as compared with the annual payment of $465.

236. Ames v. Commissioner, 58 T.C.M. (CCH) 1470 (1990).

237. There were many other participants in the Park City arrangement, whose appeals lie variously in the Fourth, Fifth, Ninth, Tenth and Eleventh Circuit Courts of Appeal. The Fifth and Ninth Circuits have both recently affirmed the Tax Court's decision in *Ames* with respect to some of these taxpayers. *See* Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991); and Hildebrand v. Commissioner, 92-1 U.S. Tax Cas. (CCH) ¶ 50,350.

238. The Tax Court had also examined whether the $2775 purchase price for the timeshare unit bore any relationship to its actual fair market value, or alternatively, whether the purchase price was inflated. After an extensive review of the testimony proffered by various expert witnesses from both parties, the Tax Court found that the timeshare unit had a fair market value of $791.80 on the date it was purchased, an amount that was far less than the purchase price of $2775. Thus, even if the Ames' expert witness was accurate in his assessment of the percentage increases in fair market value that could be expected over the life of a contract, those percentage increases, when applied to the lower figure of $791.80, would never cause the fair market value of the property to exceed the accrued amount of the debt.

> This disparity between the fair market value and the payoff amount would continue throughout the life of the loan. Petitioners would never have any equity in the property; in fact, they would always have a negative equity because the payoff amount would always exceed the fair market value of the property.

Ames, 58 T.C.M. at 1490.

239. The three-judge panel was composed of Judge Anderson, Judge Tacha and Judge Brorby.

240. Ames v. Commissioner, 91-2 U.S. Tax Cas. (CCH) ¶ 50,363 at 89,289.

241. The determination of the Tax Court concerning the fair market value of property such as the timeshare unit is a finding of fact reviewable under the clearly erroneous standard. Morris v. Commissioner, 761 F.2d 1195 (6th Cir. 1985). The Tax Court is free either to accept or to reject expert testimony if the testimony does not withstand careful analysis, and may disregard proffered expert opinion altogether and reach a determination of value based upon its own evaluation of the evidence in the record. Helvering v. National Grocery Co., 304 U.S. 282 (1938); Silverman v. Commissioner, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977); In re Williams' Estate, 256 F.2d 217 (9th Cir. 1958); Parker v. Commissioner, 86 T.C. 547 (1986). The Tenth Circuit rejected the tax-

"would be highly unlikely that the obligation would ever be paid" because it would always "cost far more to pay the debt than the property would be worth."[242] The court concluded that the only "economic incentive to retain this timeshare unit was the hoped-for ability to deduct from federal taxes far more interest than would ever be paid."[243]

In light of these determinations, the Tenth Circuit had little trouble upholding the Tax Court's determination that the indebtedness had no economic substance. The Commissioner's disallowance of the claimed interest deductions was therefore upheld.

D. *Summary*

Ames should come as no surprise. The Tax Court and the Tenth Circuit followed accepted precedent in holding that interest payable in connection with nonrecourse obligations may not be deducted under the Code in circumstances where the amount of the nonrecourse indebtedness far exceeds the fair market value of the property. The aggressive tax shelter scheme fashioned in *Ames* was particularly vulnerable to this analysis. In such cases, the debt will be viewed as having no substance, and the interest deductions attributable to the debt will be swept away.[244]

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payers' contention on appeal that the Tax Court had erroneously excluded the conclusion of its expert witness, had not given proper consideration to the admission of the Commissioner's expert with respect to the projected rate of inflation over the next thirty years, and had not paid sufficient deference to the opinions of experts about the fair market value of the timeshare unit on the date of purchase. *Ames*, 91-2 U.S. Tax. Cas. ¶ 50,363 at 89,289.

242. *Ames*, 91-2 U.S. Tax Cas. ¶ 50,363 at 89,289.

243. *Id.*

244. The Tenth Circuit's Order reserved comment on the merits of Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3rd Cir. 1988), *cert. denied sub nom.* Commissioner v. Prussin, 493 U.S. 901 (1989), and its application to the Ames' timeshare unit. In *Pleasant Summit*, the Third Circuit held that a proportionate interest deduction should be allowed to the extent of the fair market value of the collateral, at least in circumstances where the incentive of the taxpayer and the lender would be to compromise the nonrecourse debt to amount of the pledged property's fair market value. The Tenth Circuit declined to consider the "partial deduction" theory since Ames had raised the issue for the first time on appeal. For a discussion of (and apparent disapproval of) *Pleasant Summit*, see Lukens v. Commissioner, 945 F.2d 92, 97-99 (5th Cir. 1991).