Denver Law Review

Volume 61
Issue 2 *Tenth Circuit Surveys*

Article 17

February 2021

Taxation

Jennifer K. Stern

TAXATION

OVERVIEW

The Tenth Circuit Court of Appeals selected for publication approximately half of the federal taxation cases it decided in the period covered by this survey. For the most part, the court addressed routine issues and followed established precedents. Some of the issues considered, however, including third-party recordkeeper summonses and the availability of the fifth amendment privilege against self-incrimination in the tax context, are currently of major interest throughout the country. The primary consideration in preparing this article was to elucidate the Tenth Circuit's interpretation of the law in order to aid attorneys in preparing presentations to the court.

I. CRITERIA FOR IMPOSING THE ACCUMULATED EARNINGS TAX

In *Guarantee Abstract Title Co. v. United States*,[1] the Tenth Circuit Court of Appeals addressed the issue of what constituted sufficient evidence of a company's plan for using its accumulated earnings to avoid imposition of the accumulated earnings tax.[2] In contesting imposition of the accumulated earnings tax, the taxpayer must present objective evidence of a specific and definite plan for using accumulated earnings.[3] The plan need not be written.[4] The "reasonableness" of the need for the questioned accumulation is determined case by case on a fact and circumstances basis in light of the specific plan of the company in question.[5]

In *Guarantee Abstract* the Tenth Circuit affirmed the district court's judgment, finding sufficient evidence to support the jury's finding that Guarantee had a definite plan for its accumulated earnings, and that the accumulations were reasonable in light of that plan.[6] The court observed that although a formal plan would normally be contained in corporate minutes, a closely held corporation like Guarantee might be run informally and a definite plan might not be found in the minutes.[7]

The court of appeals found objective evidence of a definite plan in the testimony of the stockholders and their accountants. This testimony showed

1. 696 F.2d 793 (10th Cir. 1983).

2. I.R.C. §§ 531-537 (1982). The accumulated earnings tax is a penalty tax imposed upon corporations which accumulate earnings beyond the reasonable needs of their business. *See id.* §§ 531-533. Its purpose is to prevent avoidance of the income tax imposed on distributions to shareholders. *See id.* § 532. *See generally* United States v. Donruss Co., 393 U.S. 297, 303 (1969).

3. 696 F.2d at 795 (citing Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 433-34 (10th Cir. 1974); Henry Van Hummell, Inc. v. Commissioner, 364 F.2d 746, 750 (10th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967)).

4. 696 F.2d at 795 (citing Hogg's Oyster Co. v. United States, 676 F.2d 1015, 1018 (4th Cir. 1982)).

5. *Cf.* Treas. Reg. 1.533-1(2) (1959) (tax avoidance purpose in accumulating earnings to be determined on case by case basis).

6. 696 F.2d at 795-96.

7. *Id.* at 795.

that Guarantee, an abstract and title company, intended to become a title insurance company and required increased accumulations to insure against the higher risks associated with the title insurance business.[8] There was also evidence that the earnings were accumulated to cover anticipated increased operating expenses as well as potential policy and litigation losses.[9] The court viewed Guarantee's practice of keeping its accumulated earnings in short term notes on deposit with mortgage lenders as corroborative of its asserted plan, because that practice ensured liquidity to meet title losses and was a reasonable method of generating title business.[10] In light of Guarantee's proof of an established plan, the accumulated earnings tax was held to have been improperly assessed against Guarantee, entitling Guarantee to a refund of the accumulated earnings tax it had paid.[11]

II. MINIMUM TAX: AN INCOME TAX THAT CAN CONSTITUTIONALLY BE APPLIED RETROACTIVELY

In *Ward v. United States*,[12] the court considered several issues regarding the minimum tax. The minimum tax is a tax, in addition to the regular income tax, which is imposed on individuals and corporations having tax preference income in excess of a specified amount.[13] Congress' purpose in imposing the minimum tax was to increase the income tax liability of taxpayers who are able to reduce their taxable income drastically by claiming preferential tax treatment with respect to special income items or allowed deductions.[14]

The Wards were independent oil and gas producers who, in 1964, elected to exercise their one-time option to deduct all intangible drilling costs (IDC's) associated with their drilling programs as current expenses, rather than to capitalize and amortize those costs.[15]

In 1976, Congress added intangible drilling costs to the list of tax preference items, and imposed a minimum tax on the amount by which the one-time deduction for these costs exceeded the amount which would have been deductible if such costs had been capitalized using the straight line method of amortization.[16] This tax was imposed on the Ward's income for 1976,

8. *Id.*

9. *Id.* Evidence of Guarantee's past losses was significant in establishing the reasonableness of its reserves. *See id.* Accumulation for theoretical contingencies is insufficient to avoid the accumulated earnings penalty. *See* Cheyenne Newspapers, Inc. v. Commissioner, 494 F.2d 429, 433 (10th Cir. 1974).

10. 696 F.2d at 796.

11. *Id.*

12. 695 F.2d 1351 (10th Cir. 1982).

13. *See* I.R.C. §§ 55, 56 (1982) (amended 1983). Tax preference income includes both direct cash income and direct economic benefits such as accelerated depreciation. *E.g.*, Graff v. Commissioner, 74 T.C. 743, 766 (1980).

14. H.R. REP. NO. 91-413, 91st Cong., 1st Sess. 78, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1725 *and* 1969-3 C.B. 200, 249; S. REP. NO. 91-552, 91st Cong., 1st Sess. 113, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS, 1645, 2144 *and* 1969-3 C.B. 423, 426.

15. 695 F.2d at 1352. The Wards exercised the option provided by I.R.C. § 263(c) (1982) (amended 1983). This is an irrevocable option which a taxpayer may elect only in the first taxable year in which intangible drilling costs are incurred. *See* Treas. Reg. 1.612-4(d)(1965).

16. *See* I.R.C. § 57(a)(11), (d)(1982).

thereby increasing their tax liability.[17]

After paying the increased minimum tax and being denied a refund, the Wards sued to recover the tax paid.[18] The Wards claimed that imposing the tax retroactively to the beginning of the taxable year was unconstitutional and that, even if the retroactive application was constitutional, the tax was not an income tax but an excise tax and therefore deductible as an ordinary business expense.[19] The district court rejected these contentions, and granted summary judgment in favor of the Internal Revenue Service (IRS).[20]

A. *Retroactive Application of the Minimum Tax is Constitutional*

The Tenth Circuit held that due process is not necessarily violated by retroactive application of an income tax statute to the entire calendar year of its enactment.[21] Rather, it is necessary to consider the nature of the tax and the circumstances surrounding its enactment in order to determine whether it can be retroactively applied.[22] The court noted a distinction between imposing a tax on an activity never before taxed and changing the rate for an activity already taxed.[23] In the latter case, the taxpayer has no vested right in any particular tax rate, because it is readily foreseeable that Congress can and will change existing tax rates[24] The Wards argued, however, that they could not have forseen that IDC's would be added to the list of minimum tax preference items, and that retroactive imposition of this tax change was therefore unconstitutional as to them. This argument was rejected by the court because evidence showed that the Wards had lobbied extensively against the inclusion of IDC's as a tax preference item, and therefore should have been able to forsee the extension of the minimum tax.[25] Hence, retroactive imposition of the tax on the Wards was not unconstitutional.[26]

The court supported its holding by pointing to two policy considerations indicating that courts should defer to Congress' retroactive application of a tax. First, because the income tax is not a penalty but a means of apportioning the cost of government, retroactivity allows "better allocation" of the tax burden to those Congress decides should bear it.[27] Second, the court observed that the Supreme Court has regularly upheld the constitutionality of Congress' practice of giving general revenue statutes retroactive applica-

17. 695 F.2d at 1352.

18. *Id.*

19. *Id.* at 1352-53.

20. *Id.* at 1352.

21. *Id.* at 1353 (quoting United States v. Darusmont, 449 U.S. 292, 296-97 (1981)). *Darusmont* upheld retroactive application of increases in existing minimum tax provisions. 449 U.S. at 300-01.

22. 695 F.2d at 1353 (quoting Welch v. Henry, 305 U.S. 134, 147-48 (1938)).

23. 695 F.2d at 1354 (quoting Appendrodt v. United States, 490 F. Supp. 490, 492 (W.D. Pa. 1980) (quoting Judge Learned Hand in Cohan v. Commissioner, 39 F.2d 540, 545 (2d Cir. 1930))).

24. 695 F.2d at 1354.

25. *Id.* The district court found that Mr. Ward had made several trips to Washington during 1975-76 to lobby against the tax, and that he should therefore have considered the possibility of the tax when planning his drilling program. *Id.*

26. *Id.*

27. *Id.*

tion to the entire calendar year of enactment.[28]

B. *The Minimum Tax is an Income Tax*

The Tenth Circuit also disagreed with the Wards' contention that the minimum tax was an excise tax and hence deductible as an ordinary business expense.[29] The language of the statute states that the minimum tax is imposed "[i]n addition to the other taxes imposed by this chapter."[30] The court observed that the IRS has "consistently treated the tax as an income tax,"[31] and pointed out that all other courts which have considered the issue have found the minimum tax to be an income tax.[32] Further, the legislative history of the minimum tax indicated that Congress intended the minimum tax to be an income tax.[33] The court then rejected the Wards' claimed refund because the minimum tax, as an income tax, is "specifically barred as a deduction."[34]

III. SOLE SHAREHOLDER HAS NO RIGHT TO DEDUCT INTEREST PAID ON CORPORATE DEBT

In *Crouch v. United States*[35] the Tenth Circuit considered two claims made by the sole shareholder of a corporation: 1) that he was entitled to deduct the corporation's net operating loss from his personal return because the corporation was a subchapter S corporation,[36] and 2) that he was entitled to a personal deduction for interest paid on a loan made to his corporation.[37] The court affirmed the district court's denial of both claims.[38]

A. *Personal Deduction for Interest Paid on Corporate Indebtedness*

With respect to the interest deduction, the facts revealed that Crouch, as sole shareholder, had formed Seventeen Ventures, Inc. to build a luxury apartment complex in Florida.[39] Crouch had used the corporate form to avoid state usury law limitations on the interest which could be charged on loans to individuals.[40] Crouch personally guaranteed payment of the corporation's note, agreeing that the lender need not pursue any remedies against the corporation before collecting under the guarantee.[41] Crouch's subsequent payments on the corporate indebtedness included an interest component, which he deducted on his personal tax return.[42]

---

28. *Id.* at 1353.
29. *Id.* at 1355. See I.R.C. § 56(a)(1982).
30. I.R.C. § 56(a)(1982).
31. 695 F.2d at 1355 (citing Rev. Rul. 77-396, 1977-2 C.B. 86).
32. 695 F.2d at 1355.
33. *Id.*
34. *Id.* I.R.C. § 275(a)(1)(1982) specifically disallows deductions for federal income taxes.
35. 692 F.2d 97 (10th Cir. 1982).
36. *Id.* at 98.
37. *Id.*
38. *Id.* at 100-01.
39. *Id.* at 98.
40. *Id.*
41. *Id.*
42. *Id.*

In affirming the district court's order upholding the IRS's denial of the interest deduction, the Tenth Circuit observed that interest payments are deductible only if made with respect to a taxpayer's own debts.[43] Crouch had contended that the debt was personal to him because of the unconditional guarantee, and because the lender knew the corporation could not make the payments and expected Crouch to pay.[44] The court held, however, that the corporate form of a transaction cannot be ignored when that form has served a legitimate purpose.[45] The corporate form had served Crouch's purpose to avoid the usury laws, and he was bound to accept the tax consequences of his choice. Because the corporation was a legal entity separate from its shareholder the corporation, and not its sole shareholder Crouch, was entitled to the deduction for interest payments on corporate debt.[46]

Crouch argued alternatively that he was entitled to deduct the interest payment on the corporate debt because he was the equitable owner of the corporate assets.[47] The court held that the concept of equitable ownership applied in only two situations,[48] neither of which was present.[49] Thus, this exception did not entitle Crouch to a personal deduction for the interest paid on his corporation's indebtedness.[50]

B. *Loss of Subchapter S Status for Seventeen Ventures, Inc.*

The Tenth Circuit also considered Crouch's claim that he was entitled to a personal deduction for the 1970 net operating loss suffered by Seventeen Ventures, Inc., which had become a subchapter S corporation in 1969.[51] The court affirmed the district court's determination that because Seventeen Ventures had lost its subchapter S status, Crouch was not entitled to a deduction based on passthrough of the net operating loss.[52]

Crouch presented two arguments in opposition to this result. The government had asserted that more than twenty percent of the corporation's gross receipts were rent, which was passive investment income, and that the corporation's subchapter S status was therefore automatically terminated

43. *Id.* at 99.

44. *Id.*

45. *Id.*

46. *Id.* at 100.

47. *Id.* Treas. Reg. § 1.163-1(b) (1957) permits a taxpayer to deduct interest payments he makes pursuant to real estate mortgage when the taxpayer is the legal or equitable owner of the nortgaged property even though the taxpayer is not directly liable on the note incident to the mortgage.

48. The Tenth Circuit held that the concept of equitable ownership under Treas. Reg. § 1.163-1(b)(1957) is only applicable either 1) when a trust beneficiary has equitable title to property held by a trustee, or 2) under the doctrine of equitable conversion when real estate has been sold under a contract for a deed with legal title remaining in the seller until the total purchase price has been paid. 692 F.2d at 100. The Tenth Circuit did not rule on the IRS argument that the regulation could not, as a matter of law, apply in the close corporation context. *Id.*

49. 692 F.2d at 100.

50. *Id.*

51. *See id.* at 98.

52. *Id.* at 101.

under the existing subchapter S statute.[53] In opposition, Crouch first argued that the rent received was not passive investment income, but rather was income derived from the active business operation of the corporation, which was renting apartments.[54] The Tenth Circuit pointed out that the then-existing subchapter S explicitly listed rent as passive investment income,[55] and declined to accept Crouch's argument that the rent derived from the business of renting apartments was not passive investment income.[56]

Crouch then argued that Seventeen Ventures provided "significant services" in connection with renting its apartments, so that, under a subchapter S regulation,[57] the payments received were not "rents" within the meaning of subchapter S.[58] The court found that the services provided by Seventeen Ventures were those commonly provided in luxury apartment complexes,[59] and held that the exemption Crouch relied on was provided for operations similar to hotels and motels, not for apartment complexes providing deluxe services.[60] Hence, the rents received were passive investment income, and because those rents constituted more than twenty percent of the corporation's gross receipts, the corporation's subchapter S status was lost.[61] Given the loss of subchapter S status, there could be no passthrough of the corporation's net operating loss to Crouch.[62]

IV. FIFTH AMENDMENT PRIVILEGE AGAINST SELF-INCRIMINATION IN CIVIL TAX PROCEEDINGS

Only those subject to actual or potential criminal prosecution can claim the fifth amendment[63] privilege against self-incrimination.[64] In the federal tax context, a taxpayer can be subject to both civil and criminal penalties for an act or subject only to civil penalties, depending on the penalty provision

53. *Id.* at 100. At the time *Crouch* was decided, I.R.C. § 1372(e)(5) (1982) provided that if a subchapter S corporation received more than 20% of its gross receipts from passive investment income, its subchapter S status was automatically terminated. Congress amended subchapter S's passive income automatic termination provisions in the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, 1674 (to be codified at I.R.C. § 1362(d)(3) (1982).

54. 692 F.2d at 100.

55. I.R.C. § 1372(e)(5)(C)(1976)(amended by Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, 1674 (to be codified at I.R.C. § 1362(d)(3)(D)(1982))).

56. 692 F.2d at 101. The court relied on its decision in Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975), which held that a taxpayer in the business of making loans was not entitled to subchapter S status because subchapter S listed interest as passive investment income. *Id.* at 264.

57. Treas. Reg. § 1.1372-4(b)(5)(iv)(b)(vi)(1959) provides that rents do not include payment for use of rooms where "significant services" are rendered to the occupant. "Significant services" are rendered to an occupant if the services are primarily for his convenience and are other than those customarily rendered in connection with rental for occupancy only. Examples of "significant services" are maid services and parking of autos; heat, light, and trash collection are not such services. *Id.*

58. 692 F.2d at 101.

59. *Id.* The services included a swimming pool, party room, laundry room, message service, and others. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. U.S. CONST. amend. V, cl. 3 provides: "No person . . . shall be compelled in any criminal case to be a witness against himself. . . ."

64. Hoffman v. United States, 341 U.S. 479 (1951).

of the statute in question. The determination of whether or not a taxpayer may claim the benefit of the fifth amendment privilege depends upon whether he is subject, or has a reasonable belief that he may be subject, to criminal prosecution.[65] Among the cases the Tenth Circuit considered involving a taxpayer's assertion of the fifth amendment privilege were two in which the court reached apparently opposite conclusions.[66] A comparison of these two cases, however, illuminates the precise analysis necessary for success in this area of law rather than inconsistent holdings.

A. Mertsching v. United States

The facts in *Mertsching v. United States*[67] revealed that Mertsching, a tax preparer, was assessed penalties for "negligently or intentionally disregarding revenue rules and regulations in preparing tax returns."[68] Specifically, the IRS contended that Mertsching prepared returns which sought to assign income by means which well established case law held impermissible.[69] Mertsching paid fifteen percent of the penalties, thereby precluding immediate IRS action to collect the entire penalty,[70] and filed a suit for determination of his liability. The United States sought to depose Mertsching in that suit and Mertsching filed an objection to the deposition request, asserting that the deposition would violate his fifth amendment privilege against self-incrimination.[71] The district court granted the United States' motion to compel discovery, advising Mertsching that his case would be dismissed if he did not submit to deposition.[72] Mertsching refused to comply with the district court's order, and the court granted the United States' motion to dismiss Mertsching's suit with prejudice.[73] Mertsching appealed the dismissal to the Tenth Circuit, claiming that the proceeding was criminal in nature, and that he was therefore entitled to assert the fifth amendment privilege against self-incrimination to insulate himself from being deposed.[74]

In affirming the order of the district court the Tenth Circuit noted that the Supreme Court has held that the right against self-incrimination only applies in suits where a responsive answer to a question, or an explanation of why it cannot be answered, exposes the claimant to prosecution for a crime.[75] The Tenth Circuit further noted that the penalties assessed against Mertsching were civil, not criminal.[76] The court therefore held that Mertsching had inappropriately claimed fifth amendment protection, and that

65. *See generally* United States v. Jones, 703 F.2d 473 (10th Cir. 1983).

66. Mertsching v. United States, 704 F.2d 505 (10th Cir.), *cert. denied*, 104 S. Ct. 105 (1983); United States v. Jones, 703 F.2d 473 (10th Cir. 1983).

67. 704 F.2d 505 (10th Cir.), *cert. denied*, 104 S. Ct. 105 (1983).

68. 704 F.2d at 506. The penalties were assessed pursuant to I.R.C. § 6694(a)(1982).

69. *See* 704 F.2d at 506 & n.2.

70. *See* I.R.C. § 6694(c)(1982).

71. 704 F.2d at 506.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* (citing Hoffman v. United States, 341 U.S. 479, 487 (1951)).

76. 704 F.2d at 506. The court's decision was reached by comparing I.R.C. § 6694(a) (1982), the source of liability for negligence by tax preparers, with I.R.C. § 6653 (1982), which provides penalties for individuals negligently preparing their own tax returns. Section 6653 had

the district court had not abused its discretion in dismissing Mertsching's action based on his failure to obey a court order to provide discovery.[77]

B. United States v. Jones

In *United States v. Jones*,[78] the facts revealed that Mr. and Mrs. Jones had been the subjects of an IRS investigation of their financial affairs over a ten year period. The IRS had initiated a tax deficiency suit against the Joneses' and had pursued a civil action against them to judgment. Because the United States had collected only a small amount pursuant to that judgment, however, Mr. Jones was asked to appear at a hearing in aid of execution of judgment.[79] Jones appeared, and was questioned about the amount and sources of his income and the nature and location of his assets.[80] Jones refused to answer the questions, asserting his fifth amendment privilege against self-incrimination, and was held in contempt of court.[81] At a later hearing Mrs. Jones was also cited for contempt for refusing, on fifth amendment grounds, to answer similar questions.[82] Both appealed the contempt citations.

Jones' fifth amendment claim was based on the assertion that answering the questions could provide incriminating evidence of two crimes: 1) making a false statement to a federal officer in violation of 18 U.S.C. § 1001[83] and 2) attempted tax evasion under section 7201 of the Internal Revenue Code.[84]

1. False Statements to IRS Agent

Prior to the hearing in aid of execution an IRS agent had interviewed Jones.[85] The agent filed an uncontested affidavit with the district court stating that Jones had not provided any information at that interview.[86] The Tenth Circuit observed that because Jones had made no statement, nothing that he could have said at the judgment execution hearing could contradict statements made to a federal officer.[87] Because there was therefore no basis for criminal prosecution under 18 U.S.C. § 1001, Jones had no reasonable fear of criminal prosecution on which to base his fifth amendment claim.[88] The Tenth Circuit therefore rejected Jones' first ground for invoking the fifth amendment privilege.[89]

---

been consistently interpreted as creating civil liabilities; ergo, section 6694(a) created only civil penalties. 704 F.2d at 507.

77. 704 F.2d at 507.
78. 703 F.2d 473 (10th Cir. 1983).
79. *Id.* at 474.
80. *Id.*
81. *Id.* at 475.
82. *Id.*
83. 18 U.S.C. § 1001 (1982).
84. I.R.C. § 7201 (1982).
85. 703 F.2d at 475.
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*

2. Attempted Tax Evasion

The Tenth Circuit, however, vacated the district court's contempt order against both Mr. and Mrs. Jones because of the potential of prosecution for attempted tax evasion.[90] In an illuminating discussion of this area of law, the Tenth Circuit detailed the factors which underlie a taxpayer's successful assertion of the fifth amendment privilege.

The privilege against self-incrimination extends to civil actions, whether the claimant is a party or a witness.[91] The privilege is implicated when a question requires either "answers that would in themselves support a conviction" or answers that would "furnish a link in the chain of evidence needed to prosecute the claimant for a crime."[92] The witness may assert the privilege when his fear of incrimination is "reasonable in light of the witness' specific circumstances, the context of the questions, and the setting in which the questions are asked."[93] The privilege exists only when a real danger of prosecution exists; mere speculation that the answer will create a danger of prosecution is insufficient.[94]

In Jones' case, he had been the target of both civil and criminal investigation by the IRS for more than ten years.[95] In the early 1970's Jones had been the target of a criminal investigation for tax fraud,[96] but had been given immunity in exchange for testimony which resulted in his law partner's conviction for conspiracy to commit tax fraud.[97] Although the proceeding involving Jones' fifth amendment claim related to collecting a judgment concerning tax years 1963-69, at the time of that proceeding the IRS was suing Jones in a civil action for taxes allegedly owing for tax years 1973-79.[98] The court found the civil tax deficiency litigation against Jones indicative of both the IRS's institutional focus on Jones' tax behavior during 1973-79 and the IRS's belief that Jones had not accurately reported his income during that period.[99] If it were true that Jones willfully failed to report income for that period, he was subject to criminal prosecution.[100] Questions concerning the nature and location of his assets were therefore potentially incriminating, even though asked in the context of an unrelated civil proceeding.[101] Given Jones' prior involvement with the IRS and the ongoing civil deficiency proceedings, it was reasonable for him to fear that his answers might provide "links in a chain of evidence on criminal charges

90. *Id.* at 478-79.

91. *Id.* at 475 (citing Maness v. Myers, 419 U.S. 449, 464 (1975); Kastigar v. United States, 406 U.S. 441, 444-45 (1972)).

92. Hoffman v. United States, 341 U.S. 479, 486 (1951).

93. 703 F.2d at 476 (citing Zicarelli v. New Jersey State Comm'n of Investigation, 406 U.S. 472, 480 (1972); Malloy v. Hogan, 378 U.S. 1, 11-14 (1964); Hoffman v. United States, 341 U.S. 479, 486 (1951)).

94. 703 F.2d at 476. *See* Zicarelli v. New Jersey State Comm'n of Investigation, 406 U.S. 472 (1972).

95. 703 F.2d at 476.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. A willful attempt to avoid tax liability is a felony. I.R.C. § 7201 (1982).

101. 703 F.2d at 476.

of attempt to evade payment of taxes."[102]

3. IRS Use of Affidavits Asserting no Current Prosecution

The Tenth Circuit also addressed the propriety of the district court's apparent reliance on an IRS affidavit in reaching its conclusion that Jones was not entitled to assert the privilege against self-incrimination.[103] The affidavit, prepared by an IRS agent, stated that no criminal charges had been referred to the Justice Department and that no criminal investigation of Jones was pending.[104] The court of appeals stated that the fact that no criminal prosecution was pending was not a guarantee that there would be no future prosecution,[105] and pointed out that the government might discover something from answers to its questions that might cause it to decide to prosecute Jones criminally.[106] Because the district court's obligation in the self-incrimination inquiry is solely to determine whether answers would tend to incriminate the witness, the court acted incorrectly in attempting to speculate whether the witness would in fact be prosecuted.[107] The court noted that the government's legitimate interest in collecting judgments cannot be allowed to override legitimate fifth amendment claims, and that if the government was in fact interested only in collecting the civil judgment, it could grant Jones immunity in exchange for the privileged information.[108]

4. Derivative Claim of Immunity

Although Mrs. Jones was never herself the target of an IRS criminal investigation, she was both a target of the civil investigation relating to the 1973-79 tax years and a party to the judgment debtor action relating to the 1963-69 tax years.[109] The Tenth Circuit vacated the contempt order against Mrs. Jones, holding that she shared her husband's reasons for fearing criminal prosecution for tax evasion.[110] Because she had filed jointly with her husband, questions relating to her husband's assets would tend to incriminate both spouses.[111] Therefore, she too could validly claim the protection afforded by the fifth amendment.[112]

C. *Contrasting* Mertsching *and* Jones

In comparing the results in *Mertsching* and *Jones*, it is crucial to recognize that in *Mertsching* the fifth amendment claim was asserted under a statute which provided only civil penalties.[113] No potential for criminal prosecution under any other statute could have resulted from Mertsching's

102. *Id.* at 477.
103. *See id.*
104. *Id.*
105. *Id.* at 478.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.* at 479. The Joneses had filed joint tax returns for all the years in question. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *See supra* notes 75-77 and accompanying text.

compliance with the discovery order. In contrast, the Joneses' fifth amendment claims were asserted with specific reference to a statute providing criminal penalties for conduct which might be revealed by their answers.[114] *Jones* highlights the need for attorneys to be aware of the potential for prosecution under criminal statutes when representing clients in civil tax proceedings.

V. THIRD-PARTY RECORDKEEPER CASES

Cases involving third-party recordkeepers[115] are of great current interest in the tax context as well as in the securities context.[116] They involve significant privacy issues. The Tenth Circuit considered a number of these cases in the period covered by this survey.

Sections 7601-7611 of the Internal Revenue Code[117] contain the provisions for examination and inspection of tax records held by third parties. The IRS is empowered to make such examinations and inspections as a means of determining the tax liability of any person.[118] Pursuant to this authority, the Internal Revenue Service may cause a summons to issue requiring the taxpayer or any person having "possession, custody, or care of books of account containing entries relating to the business of the taxpayer to produce such records for inspection."[119] Special procedures are provided for third-party summonses.[120] Where the summons does not identify the person with respect to whose liability the summons is issued, a so-called "John Doe summons" is used.[121] To obtain a John Doe summons, the IRS must establish, in a court proceeding, 1) that the summons relates to an investigation directed at a particular person or group of persons; 2) that a reasonable basis exists for believing that such person or group either has failed, or may fail, to comply with the provisions of the internal revenue laws; and 3) that the information sought to be obtained from an examination of the records, including the identity of the taxpayer, is not readily available from other sources.[122]

A. *Taxpayer Challenge to Validity of John Doe Summons Permitted*

United States v. Brigham Young University[123] is an especially interesting case in this area of the law even though it has no precedential value.[124] Brigham

114. *See supra* note 100 and accompanying text, and text accompanying notes 110-11.

115. A third-party recordkeeper is a person having possession, custody, or care of accounting books containing entries relating to a taxpayer's business. *See* I.R.C. § 7602(a)(2)(1982).

116. *See* Jerry T. O'Brien, Inc. v. S.E.C., 704 F.2d 1065 (9th Cir. 1983).

117. I.R.C. §§ 7601-7611 (1982).

118. *See* I.R.C. § 7601 (1982).

119. *See* I.R.C. § 7602(a)(2) (1982).

120. *See generally* I.R.C. § 7609 (1982).

121. *See generally* Friedland, *Internal Revenue Service Investigations of Unidentified Persons*, 60 DEN. L.J. 573 (1983).

122. *See* I.R.C. § 7609(f) (1982).

123. 679 F.2d 1345 (10th Cir. 1982), *cert. granted* and *decision vacated and remanded for consideration of mootness*, 103 S.Ct. 713, *decision vacated and appeal dismissed on remand*, No. 80-1508 (10th Cir. April 13, 1983).

124. *See infra* text accompanying notes 146-48.

Young University (BYU) is a tax exempt institution of higher learning.[125] Gifts to BYU are considered charitable contributions deductible from the donor's income.[126] In the case of gifts in-kind, donors are allowed a deduction equal to the fair market value of the gift.[127]

The IRS had audited the returns of 162 donors of gifts in-kind to BYU, and in every case discovered that the donor had overvalued his gift.[128] The IRS, after complying with statutorily required procedures, was granted a John Doe summons.[129] BYU refused to comply with the summons[130] and the United States instituted enforcement proceedings.[131] At the enforcement hearing, BYU asserted that the IRS had failed to establish a reasonable basis for believing that the in-kind donations of the taxpayers whose records were sought had been overvalued,[132] and that the government had therefore failed to comply with the statutory requirements for obtaining the John Doe summons served on BYU.[133] The district court agreed with BYU, and refused to enforce the summons.[134] The United States appealed.[135]

On appeal, the government asserted that BYU could not challenge, in an enforcement proceeding, the determination made in the ex parte summons hearing that the IRS had established the required reasonable basis for believing potential or actual violations of the tax laws existed.[136] The Tenth Circuit disagreed, holding that although the initial determination of the government's reasonable basis could be made on an ex parte basis, a taxpayer subject to an enforcement proceeding could challenge the summons on "any appropriate grounds."[137] Thus, BYU had the right to challenge the reasonableness of the IRS's belief that BYU's in-kind donors might have violated the revenue laws.[138]

The Tenth Circuit concluded, however, that the IRS had in fact estab-

125. *See* I.R.C. § 501(c)(3) (1982), which exempts from taxation corporations organized and operated exclusively for educational purposes.

126. *See* I.R.C. § 170(a)(1), (c)(2) (1982).

127. *See* Treas. Reg. § 1.170A-1(c)(1), T.D. 7207, 1972-2 C.B. 108, 116.

128. 679 F.2d at 1348.

129. *Id.* at 1346-47. I.R.C. § 7609(f) (1982) requires a showing of relevance and necessity to obtain a John Doe summons. I.R.C. § 7609(h)(1) (1982) provides that such a summons may issue after an ex parte hearing in which the court may determine the facts solely on the basis of the IRS's petition and supporting documents.

130. 679 F.2d at 1347.

131. *Id.* I.R.C. § 7402(b)(1982) and I.R.C. § 7604(a)(1982) both grant federal district courts jurisdiction to enforce an IRS summons.

132. 679 F.2d at 1347.

133. *Id.* As noted above, under I.R.C. § 7609(f)(1982) a John Doe summons will not be issued unless the IRS shows it has a reasonable basis for believing the object of its investigation may fail, or may have failed, to comply with the internal revenue laws. *See supra* note 122 and accompanying text.

134. 679 F.2d at 1347.

135. *Id.* at 1346.

136. *Id.* at 1347.

137. *Id.* at 1348 (citing Reisman v. Caplin, 375 U.S. 440, 446 (1964)). *Accord* United States v. Pittsburgh Trade Exch., Inc., 644 F.2d 302 (3d Cir. 1981). The Tenth Circuit also indicated that the district court had the power, in an enforcement proceeding, to challenge a John Doe summons sua sponte. *See* 679 F.2d at 1348 (citing United States v. Powell, 379 U.S. 48, 58 (1964)).

138. 679 F.2d at 1348.

lished the required "reasonable belief."[139] The government had audited the returns of 162 contributors in kind to BYU, and every contributor had claimed a deduction for more than the fair market value of his gift.[140] The government argued, and the Tenth Circuit agreed, that this constituted a reasonable basis for believing that BYU's other contributors of gifts in-kind *might* also have overvalued their gifts.[141] The court cited decisions in the Third[142] and Sixth[143] Circuits to support its holding that the test the IRS must meet in order to enforce a John Doe summons is one of "reasonableness," not of certainty.[144]

Pending Supreme Court review of a petition for certiorari, BYU produced the names of the contributors of gifts in-kind, whereupon, pursuant to the procedure mandated by the Supreme Court decision in *United States v. Munsingwear*,[145] the government moved to dismiss the appeal on grounds of mootness.[146] The Supreme Court then vacated the Tenth Circuit's decision and remanded the case for the Tenth Circuit to consider the issue of mootness.[147] The Tenth Circuit then vacated its judgment, withdrew its opinion, and dismissed the appeal.[148] The author has included the discussion of this case not for its precedential value, but rather to illuminate the Tenth Circuit's analysis in this important area of law.

B. *Limiting Recordkeeper Summonses on Relevancy and Undue Burden Grounds*

In *United States v. Southwestern Bank & Trust Co.*,[149] the Tenth Circuit considered the standards for judicial enforcement of a third-party recordkeeper summons.

1. Standard of Relevancy

In *Southwestern Bank*, the IRS was investigating the 1977-78 tax liability of three individual taxpayers and five corporations in which the individual taxpayers had an ownership interest.[150] Recordkeeper summonses sought bank records, including checks, loan records, and deposit records, pertaining to individual and corporate transactions from February 1, 1976 through May 31, 1979.[151] The IRS asserted a need for the documents in order to determine whether corporate distributions to the individual taxpayers during 1977 and 1978 were properly characterized as dividends or as return of capital.[152] The taxpayers intervened[153] and instructed the bank not to com-

139. *Id.* at 1350.
140. *Id.* at 1349.
141. *Id.* The Tenth Circuit emphasized that the IRS was only required to establish that a taxpayer *might* have failed to comply with the tax laws. *Id.*
142. United States v. Pittsburgh Trade Exch., Inc., 644 F.2d 302 (3d Cir. 1981).
143. *In re* Tax Liability of John Does, 671 F.2d 977 (6th Cir. 1982).
144. 679 F.2d at 1349.
145. 340 U.S. 36 (1950).
146. *See* United States v. Brigham Young Univ., 103 S.Ct. 713 (1983).
147. *Id.*
148. United States v. Brigham Young Univ., No. 80-1508 (10th Cir. April 13, 1983).
149. 693 F.2d 994 (10th Cir. 1982).
150. *Id.* at 995.
151. *Id.*
152. *Id.*

ply with the summons.[154] When the IRS sought judicial enforcement of the summonses, the taxpayers objected on the basis that the information sought was not relevant to the IRS investigation.[155] The district court refused to order enforcement of the entire summons, finding some of the requested records and checks not relevant to the IRS's investigation.[156]

The Tenth Circuit reversed the district court's order denying enforcement in part, holding that a summons seeking records must be enforced upon a showing that the IRS has complied with proper administrative procedures, that the information sought is not in IRS possession, and that the material sought *may* be relevant to a proper purpose.[157] Material is relevant for summons enforcement purposes if it tends to shed light on the accuracy of a taxpayer's return.[158]

An IRS agent testified that the corporate bank records for the entire corporate year would aid the IRS in ascertaining the accuracy of the taxpayers' returns.[159] The court found that this uncontroverted testimony satisfied the relevancy standard, and reversed the district court order denying production of specified corporate records.[160]

The district court's denial of IRS request for production of all checks cashed by taxpayers during the periods in question was mooted on appeal when the intervenors agreed with the government that the materials sought were relevant.[161] The Tenth Circuit pointed out, however, that the judiciary had discretion to limit the required compliance to protect the third-party recordkeeper from excessive burden or expense in complying with the summons.[162] The court then remanded the case to allow the district court to consider appropriate limitations and procedures for enforcing the summons.[163]

VI. CRITERIA FOR DETERMINING WHETHER PERIODIC PAYMENTS ARE ALIMONY OR PROPERTY SETTLEMENT

At issue in *Gammill v. Commissioner*[164] was whether periodic payments made to an ex-spouse were tax deductible alimony payments or non-deducti-

153. Under I.R.C. § 7609(a)(1) (1982) the person(s) whose records have been summoned is entitled to notice of that fact after service of the summons. Under *id.* § 7609(b)(2) that person is entitled to intervene in any proceeding with respect to enforcement of the summons and to request the recordkeeper not to comply with the summons. If the taxpayer instructs the recordkeeper to withhold the records, the IRS must either obtain the individual's consent or a court order before it can force the recordkeeper to provide the requested information. *Id.*

154. 693 F.2d at 995.

155. *See id.* at 995-96.

156. *Id.* at 995.

157. *Id.* (quoting United States v. City Nat'l Bank & Trust Co., 642 F.2d 388, 389 (10th Cir. 1981) (quoting United States v. Powell, 379 U.S. 48, 57-58 (1964))).

158. 693 F.2d at 996 (citing City Nat'l Bank & Trust Co., 642 F.2d 388, 389 (10th Cir. 1981) (quoting United States v. Davey, 543 F.2d 996, 1000 (2d Cir. 1976))).

159. 693 F.2d at 996.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. 710 F.2d 607 (10th Cir. 1982).

ble installment payments made pursuant to a property settlement.[165]

A. *The Tax Court Decision*

The IRS assessed tax deficiencies against Gammill because he had treated payments to his ex-spouse, Marjorie, as deductible alimony rather than as non-deductible payments pursuant to a property settlement.[166] The Tax Court held that the payments were not alimony but were part of a property settlement, and ordered Gammill to pay the amount of the disallowed deductions.[167] The Tax Court determined the nature of the payments by reference to general characterization principles and by reference to the law of Oklahoma,[168] where the Gammills were divorced.[169] The Tax Court noted that Oklahoma law permitted a court granting a divorce to designate, in the divorce decree, the dollar amount of any periodic payments which were for support.[170] The Tax Court found it significant that language requiring the payments to be regarded as alimony was absent from the Gammills' divorce decree.[171] In light of the language of the decree, the amount of the total payments, and Mrs. Gammill's contribution to the marriage, the Tax Court held that the payments did not constitute alimony.[172]

B. *The Tenth Circuit Decision*

In reviewing the Tax Court's determination, the Tenth Circuit noted that under the Internal Revenue Code payments which are "periodic" and "arise out of a family or marital obligation to support" are includible in the recipient's taxable income,[173] and are therefore deductible as alimony.[174] Since Gammill's payments extended over a period of more than ten years they were periodic.[175] Thus, the issue was whether the payments constituted a support obligation.[176]

In affirming the Tax Court's determination that the payments were a property settlement, rather than a support obligation, the court enumerated five factors as guides to determine the nature of periodic payments made following a divorce: 1) whether there was a fixed sum, 2) whether the payments are related to the obligor's income, 3) whether the payments continue despite the obligee's death or remarriage, 4) whether the obligee gives consideration for the payments, and 5) whether the obligor provides security to

165. *Id.* at 608. Alimony payments are deductible under I.R.C. § 215 (1982).
166. 710 F.2d at 608.
167. Gammill v. Commissioner, 73 T.C. 921, 926 (1980), *aff'd*, 710 F.2d 607 (10th Cir. 1982).
168. 73 T.C. at 926-30.
169. 710 F.2d at 608.
170. 73 T.C. at 927 & n.4 (quoting OKLA. STAT. tit. 12, § 1289(B)(1971) (recodified as amended at OKLA. STAT. tit. 12, § 1289(A)(1981))).
171. 73 T.C. at 927.
172. 73 T.C. at 926.
173. *See* I.R.C. § 71(a)(1982).
174. 710 F.2d at 608-09. *See* I.R.C. § 215 (1982) (providing deduction for alimony payments).
175. 710 F.2d at 609 (1982))
176. *Id.*

ensure payment.[177] If these factors are present, payments are to be considered a property settlement.[178] The Tenth Circuit found the payments to be in satisfaction of a property settlement on the basis of the following facts: 1) at the time of the divorce, the Gammills entered into an agreement entitled "Property Settlement Agreement" under which a lump sum was payable in equal monthly installments over a twenty-year period, 2) the amount was secured by a lien against a portion of stock owned by Mr. Gammill, 3) the divorce decree referred to the lump sum amount as "part of" property and assets set over to Marjorie Gammill, 4) the entire amount unpaid was due upon the death of Gammill or if he was in default more than thirty days, and 5) the property settlement would inure to the benefit of Marjorie's heirs and assigns, should she die prior to the complete payment of all installments.[179]

VII. CRITERIA FOR DETERMINING TIME OF A STOCK REDEMPTION

In *Barton Theater Co. v. Commissioner*,[180] the Tenth Circuit affirmed the United States Tax Court's determination that a stock redemption had occurred in 1966 rather than, as Barton alleged, in 1967.[181] The court noted that a decision on the timing of the redemption is not fixed by the time the shares are transferred, but is based on a practical consideration of all the facts surrounding a transaction.[182] The factors which persuaded the Tax Court, and the Tenth Circuit, that the redemption took place in 1966 were the presence of: 1) formal agreements covering the redemption and all its details, signed and notorized in January, 1966; 2) 1966 accounting entries on the books of both corporations involved reflecting full consummation of the agreement; 3) audited balance sheets for both corporations reflecting the fact that the redemption was completed in 1966; 4) a 1969 proxy agreement and a 1970 letter declaring that Barton had acquired the shares of Atlas Corporation in January, 1966; and 5) Barton's Board of Directors minutes adopting the stock redemption agreement at a January 1, 1966 meeting.[183] All these factors, stated the court, reflected the intention of the parties that the redemption occur in 1966.[184]

Jennifer K. Stern

177. *Id.* at 610. These five factors were first listed in Riley v. Commissioner, 649 F.2d 768 (10th Cir. 1981).

178. 710 F.2d at 610.

179. *Id.* at 608-09.

180. 701 F.2d 126 (10th Cir. 1983).

181. *Id.* at 128.

182. *Id.* The following factors were listed as significant: passage of legal title; transfer of possession; fixed sales price; timing of transfer of consideration; the parties' intention; the language of the agreements; and whether the parties have chosen a particular effective date for the agreement. *See id.*

183. *Id.* at 128-29.

184. *Id.* at 128.