Denver Law Review

Volume 56 | Issue 2 Article 13

February 2021

Taxation

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Overview

The tax cases decided by the Tenth Circuit during 1977 represent consistent, conforming applications of the law with no departures from tax principles established previously either by the Tenth Circuit or by other jurisdictions.[1] Nevertheless, several of the cases are worth noting for they delineate the current status of the tax law in their respective fields.[2]

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[1] The Tenth Circuit had the opportunity to decide several cases, regarding tax protest litigation, which are more interesting from a sociological than a legal standpoint. The leading and dispositive case, in a series of four cases, is United States v. Carroll, 567 F.2d 955 (10th Cir. 1977). Following the pattern of tax protest cases, all four cases allege constitutional claims, specifically contending that the taxpayer's constitutional privileges under the first (freedom of religion), fourth (protection of privacy) and fifth (freedom from self-incrimination) amendments have been violated by the Internal Revenue Service. *See* United States v. Carroll; United States v. Johnson, No. 77-1366 (10th Cir. Mar. 22, 1978) (Not for Routine Publication); Ellison v. Commissioner, No. 76-2178 (10th Cir. Jan. 20, 1978) (Not for Routine Publication); and United States v. Cotton, 567 F.2d 958 (10th Cir. 1977).

The Tenth Circuit, relying on well established Supreme Court precedent and on prior Tenth Circuit cases, dismissed all of the constitutional arguments as meritless. *See, e.g.*, United States v. Carroll, (relying on Gillett v. United States, 401 U.S. 437, 439 (1971); Hoffman v. United States, 341 U.S. 479, 486 (1951); Cantwell v. Connecticut, 310 U.S. 296, 304 (1940); and Reynolds v. United States, 98 U.S. 145, 166-67 (1878)).

The *Johnson* case made the unusual argument that the taxpayer's conviction should be overturned because the jury panel was not a fair cross section of the community since it had a disproportionate number of Cheyenne residents and federal and state employees. The tax protester also argued that the oath taken by the jurors was not in compliance with Article 6, clause 3 of the Constitution which requires all judicial officers to be bound by oath to support the Constitution. No. 77-1366, slip. op. at 2.

The *Johnson* and *Ellison* cases set forth the incredible argument that they had no income during the years in question for all of their income was in the form of federal reserve notes which are not actual dollars because they are not redeemable in gold or silver. This argument was rejected as meritless on its face by the Tenth Circuit.

[2] Other cases were decided by the Tenth Circuit, but are not included within the discussion of this note: United States v. New Mexico, No. 76-1888 (10th Cir. Aug. 7, 1978) (New Mexico's gross receipt tax on expenses and equipment purchased by contractors, who had cost plus contracts with the United States which included state and local taxes within the definition of reimbursable costs, was not unconstitutional because the legal incidence of the New Mexico tax was on the contractors as sellers of services to the United States. *Id.* at 5-10. Further, the New Mexican compensating or use tax placed on reimbursements for property purchased out-of-state and brought into New Mexico for use under government contracts was valid as, again, the legal incidence of the tax was on the contractors as purchasers who brought the materials and supplies into New Mexico. *Id.* at 10. Finally, the court upheld the rule that a gross receipt tax can be placed on only those reimbursed general and administrative expenses which arise from contracts and services performed within New Mexico's borders. *Id.* at 16-17.); Central Motor Co. v. United States, 583 F.2d 470 (10th Cir. 1978) (Whether or not a corporation has accumulated its earnings and profits beyond the reasonable needs of its business, including reasonably anticipated needs, is a factual determination. *Id.* at 476. The opinion dis-

I. THE DEDUCTIBILITY OF PAYMENTS FOR CATTLE FEED: *Weisbart v. Commissioner*[3]

Unlike most taxpayers engaged in the production of goods for sale who are forced to use the accrual method of accounting in order to accurately reflect income,[4] farmers[5] engaged in the business of raising livestock for profit have been entitled since 1915 to file their returns on the cash basis method and hence, deduct most production costs in the year of payment irrespective of when the associated income is earned.[6] This allowed farmers to manipulate their taxable income by incurring expenses prematurely, which in turn created a substantial business in the use of farms as tax shelters. One frequently employed manipulative technique involved the prepaid feed expense. Feed to be used during the ensuing year would be prepaid in December to obtain, at that time, the concomitant deduction.[7] Understandably, this device became the subject of substantial litigation.[8]

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cusses the factors which the Tenth Circuit, and other jurisdictions, consider as indicating whether the accumulation was reasonable. *Id.* at 476-77 (citing Treas. Reg. § 1.537-2(b), (c) (1960), and Ivan Allen Co. v. United States, 422 U.S. 617, 626-28 (1975) (which the Tenth Circuit viewed as laying down the basic guidelines for the determination of whether or not earnings had been accumulated unreasonably). *See* Case, *Accumulated Earning Tax Aspects of Business Expansions and Investments*, 32 TAX L. REV. 1, 64-65 (1976)); Jacobs Equipment Co. v. United States, 574 F.2d 1040 (10th Cir. 1978) (The act of welding a hoist to a truck body did not constitute "manufacture" of a truck body within the meaning of 26 U.S.C. § 4061(a)(1)); Stern v. United States, No. 76-1550 (10th Cir. Sept. 23, 1977) (Not for Routine Publication) (Parole evidence could not be used to supply the necessary, but unexpressed, restrictions in an instrument of gift in order for the gift to qualify for a charitable deduction.).

[3] 564 F.2d 34 (10th Cir. 1977).

[4] *See generally* I.R.C. §§ 446(a)-(c), 471; Treas. Reg. §§ 1.471-1 (1960), 1.471-11 (1973), 1.446-1(c)(20) (1957); *see also* Comment, *Farmers' Prepaid Feed Deductions: Mann v. Commissioner*, 1974 WASH. U.L.Q. 485.

[5] The word "farmers" includes "individuals, joint venturers, partnerships, corporations, or other entities engaged in the business of raising livestock for profit . . . ." Pinney & Olsen, *Farmers' Prepaid Feed Expenses*, 25 TAX LAW. 537 (1972).

[6] Comment, *supra* note 4 at 487-88, *citing* T.D. 2153, 17 TREAS. DEC. INT. REV. 101 (1915). The relevant language for our purposes is now found in Treas. Reg. § 1.162-12(a) (1972), which states in part:

> A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming . . . . The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . . .

[7] *See* Comment, *supra* note 4, at 487-89.

[8] *See, e.g.*, Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973), *rev'g* 41 T.C.M. (P-H) 843 (1972); Shippy v. United States, 308 F.2d 743 (8th Cir. 1962), *aff'g* 199 F. Supp.

Weisbart v. Commissioner represents the most recent case of this type. Taxpayer Weisbart was the 100% owner of the G. Weisbart and Co., a cash method business whose purpose was the buying and selling of cattle. Weisbart was also the ninety-two percent owner of the stock of the 7A Land and Feeding Company. The two corporations entered into a transaction whereby Weisbart and Co. purchased $100,106 worth of feed from 7A Land and Feeding Company. In payment for the feed Weisbart and Co. gave to the 7A Company $100,106 worth of contract rights to purchase cattle. The feed was purchased on December 16, 1968, and the evidence established that the major portion of the feed was not used until 1969. The 7A Company did not take advantage of the contract rights that it obtained from the transaction, and on March 31, 1969, Weisbart and Company repurchased all of the contract rights at the original price.[9]

The Tenth Circuit upheld the decision of the Tax Court in rejecting Weisbart and Company's deduction for feed expenses in 1968.[10] The court first held that what constitutes payment by a cash method taxpayer is a question of federal, rather than state, law and it was open to the Tax Court to conclude that there was no geuine payment in 1968 resulting from the transfer of the contract rights.[11]

In resolving the particular situation presented by this litigation the court cited the well-worn tenets of tax law that (1) the character of a taxpayer's transaction or arrangement is controlled by substance rather than form, (2) findings as to what is the substance of a transaction are to be treated as questions of fact and (3) a trial court's findings of fact are to be upheld unless clearly erroneous.[12] The Tax Court's finding as to the substance

842 (D.S.D. 1961); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959), *rev'g* 30 T.C. 903 (1958); Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971); Estate of Cohen, 39 T.C.M. (P-H) 1331 (1970); Tim W. Lillie, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966); John Ernst, 32 T.C. 181 (1959), *acq'd in* 1959-2 C.B. 4. *See generally* Pinney & Olsen, *supra* note 5.

[9] 564 F.2d at 35.

[10] In reaching this decision, the Tenth Circuit declined to address the issue of piercing the corporate veil between these two corporations. The court stated that the question to be decided was what constituted payment by a cash method taxpayer which is a question of federal, not state law, and does not depend on the relationship between the two corporations. *Id.* at 36.

[11] *Id.*

[12] *Id.* at 36-37.

of the transaction was that the parties at all times intended the 1969 repurchase and, therefore, the 1968 transfer was not genuine. The Tenth Circuit supported this finding with the following factors: (1) Weisbart was the owner of 92% of the stock of the 7A Company and the owner of 100% of the stock of Weisbart and Company; (2) the repurchase price was exactly the same as the original price, which was significant because the value of contract rights such as these are subject to substantial fluctuation; (3) if the transfer had been real, it would have placed the cattle under the ownership of the feed corporation, thereby defeating the purpose of the separate incorporation of the two companies; and, (4) the availability to Weisbart of a line of credit at a bank, which had been increased on December 20, 1968, a few days after the transaction, refuted the contention that the contract rights had been used due to a shortage of available cash, and supported the eventual conclusion that the transfer had been intended to be a temporary one.[13]

In reaching its conclusion the Tenth Circuit relied on well-known precedents[14] developing the factors which, if met, will allow a farmer to deduct the prepayment of feed.[15] The factors can be summarized as follows:

> (1) The payment should be an actual outlay of money (*i.e.*, cash, not notes);
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> (2) there should be a binding written contract specifying price and quantity;
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> (3) there should be no provision for refunds, *i.e.*, the expenditure must be for payment only, not a deposit;

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[13] *Id.* at 36.

[14] The Tenth Circuit specifically relied on Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973); Shippy v. United States, 308 F.2d 743 (8th Cir. 1962); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); John Ernst, 32 T.C. 181 (1959), *acq'd in* 1959-2 C.B. 4. Treasury Regulations relied on were as follows: Treas. Reg. §§ 1.446-(1)(c)(1)(i) (1973), 1.461-1(a)(1) (1967), 1.62-12(a) (1972).

[15] In order to preserve his deduction, the taxpayer must first qualify as a farmer. *See, e.g.*, Hi-Plains Enterprises v. Commissioner, 496 F.2d 520 (10th Cir. 1974); United States v. Chemell, 243 F.2d 944 (5th Cir 1957). Treasury Regulations define "farm" and "farmer" as follows:

> As used in this section, the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers.

Treas. Reg. § 1.61-4, T.D. 7198, 1972-2 C.B. 166. *See also* Treas. Reg. §§ 1.175-3, -4 (1957), 1.182-2 (1965).

(4) only reasonable amounts of feed for the number of cattle to be fed should be purchased;
(5) risk of loss (*e.g.*, ownership) should pass to the taxpayer;
(6) services (*e.g.*, yardage, veterinary services, etc.) should not be prepaid;
(7) a valid business purpose (*e.g.*, to insure supply, obtain preferential treatment or delivery, establish a set price, etc.) should be present, not mere tax avoidance.[16]
(8) the payment must not materially distort the taxpayer's income.[17]

The payment/deposit test is uniformly supported by the case law,[18] and it was the major factor in the Tenth Circuit's upholding of the Tax Court's refusal of the deduction. The court noted that transactions of this nature that have been upheld usually involve payments in cash,[19] but the true deciding factor is the finality of the payments.[20] The court also reviewed several cases concluding that notes cannot be the basis for a deduction for a cash basis taxpayer since a cash basis taxpayer can only claim a deduction for payments made in cash or its equivalent; notes from a cash basis taxpayer are not the equivalent of cash since such notes are merely promises to pay, which may not be fulfilled.[21]

The court ended by observing that Weisbart, being a cash-basis taxpayer, would be allowed to take a deduction in the year cash or its equivalent was paid, and

> [I]n the case of an executory contract of sale in which payments are deferred and are evidenced only by the contracts, the deferred payments are ordinarily not taxed to the cash basis seller until received . . . . The cash equivalency rule is the same for items of income as it is for deductions . . . . Payments under such a contract are not deductible by the purchaser who is on a cash basis until the actual payment.[22]

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[16] *See generally* cases cited note 8 *supra;* and Rev. Rul. 75-152, 1975-1 C.B. 144. *See also* Pinney & Olsen, *supra* note 5, at 542-43; Willingham & Kasmir, *Prepaid Feed Deduction: How to Cope with the IRS' Restrictive New Ruling*, 42-43 J. TAX. 230 (1975).

[17] Weisbart v. Commissioner, 564 F.2d 34; Rev. Rul. 75-152, 1975-1 C.B. 144. *See also* Willingham & Kasmir, *supra* note 15, at 230-31.

[18] *See, e.g.*, Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973), *rev'g* 41 T.C.M. (P-H) 843 (1972); Shippy v. United States, 308 F.2d 743 (8th Cir. 1962), *aff'g* 199 F. Supp. 842 (D.S.D. 1961); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Estate of Cohen, 39 T.C.M. (P-H) 1331 (1970); John Ernst, 32 T.C. 181 (1959).

[19] *See generally* authorities cited note 17 *supra*.

[20] 564 F.2d at 38.

[21] Cases reviewed by the court included: Don E. Williams Co. v. Commissioner, 429 U.S. 569, 577-78 (1977); Baltimore Dairy Lunch, Inc. v. United States, 231 F.2d 870 (8th Cir. 1956). The Tenth Circuit also relied on Treas. Reg. §§ 1.446-1(c)(1)(i) (1973), 1.461-1(a)(1) (1967); and 2 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 11.02 (1974).

[22] 564 F.2d at 38.

The court then stated that due to the lack of substance found by the Tax Court in the transaction, which was supported in the mind of the Tenth Circuit by the facts enunciated above, the transfer of the contract rights brought the case within the rule applicable to executory contracts.[23]

Weisbart re-emphasizes the importance of the factors outlined above. Cash basis farmers within the jurisdiction of the Tenth Circuit should never lose a deduction for the prepayment of feed if they simply conform to the guidelines delineated by the Internal Revenue Service and the Tenth Circuit.

II. THE TAXATION OF PATENT TRANSFERS: *Eickmyer v. Commissioner*[24]

The eligibility of patent transfers for treatment as capital transactions has long been an area of controversy. In the past, the difficulty lay not in the nature of the property transferred but rather in the manner in which it was transferred. Frequently, the seller received his consideration in the form of "royalties" over a period of time, usually coterminous with the life of the patent, and he retained some degree of control over the patent until the purchase price was paid.[25] This form of transfer created problems in meeting the Internal Revenue Code requirement that, for capital gains treatment, there must be a sale or exchange of the property.[26] On the basis of two early Supreme Court cases,[27] the Commissioner maintained for several years that if the consideration received for a patent was in the form of "royalties" paid over a period coterminous with the life of the patent, the transaction was a license and could not be treated as a sale within the meaning of the Internal Revenue Code.[28]

One of these cases, *Waterman v. Mackenzie*,[29] still remains as precedent for the taxation of patent sales. Even though *Waterman* itself is not a tax case, it has been cited as authority

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[23] *Id.*

[24] 580 F.2d 395 (10th Cir. 1978).

[25] Comment, *Capital Gains Treatment of Proceeds from Patent Transfers*, 34 MO. L. REV. 98, 99 (1969).

[26] I.R.C. § 1231.

[27] United States v. General Electric, 272 U.S. 476 (1926); Waterman v. MacKenzie, 138 U.S. 252 (1891).

[28] Comment, *supra* note 25, at 99.

[29] 138 U.S. 252 (1891).

in nearly every patent tax case involving the question of a "sale or exchange" within the past two decades.[30] In *Waterman*,[31] the Supreme Court held that:

> The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or, 2d, an undivided part or share of the exclusive right; or 3d, the exclusive right under the patent within and throughout a specified part of the United States . . . . Any assignment or transfer, short of one of these, is a mere license, giving the licensee no title in the patent, and no right to sue at law in his own name for an infringement . . . .[32]

It was this language that established the basic criteria for a sale of a patent for federal income tax purposes, and provided support for the position that periodic payments received for the use of a patent could not qualify for capital gains treatment.[33]

A turning point for the taxpayer/inventor came in the case of *Edward C. Myers*.[34] Myers had transferred the exclusive right to use, manufacture, and sell his patented invention, but he had retained the right to terminate the agreement if a certain amount of royalty payments were not made, and the transferee had the right to terminate after a certain date.[35] The Commissioner argued that these provisions were inconsistent with a sale of a patent and therefore no capital gains treatment could be accorded the transfer. The Supreme Court rejected this argument

[30] *See, e.g.*, Eickmeyer v. Commissioner, 580 F.2d 395 (10th Cir. 1978); Commissioner v. Celanese Corp. of America, 140 F.2d 339 (D.C. Cir. 1944); Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Claude Neon Lights, Inc. 35 B.T.A. 424 (1937); Julius E. Lilienfeld, 35 B.T.A. 391 (1937); Parke, Davis & Co., 31 B.T.A. 427 (1934), *cited in* Comment, *supra* note 25, at 100 & n. 16.

[31] In *Waterman* the plaintiff was suing for infringement of a patent, posing his right to sue on an agreement whereby the owner of the patent had granted him the "sole and exclusive right to manufacture and sell under the patent." The defendant claimed that the plaintiff had no right to sue because he was a mere licensee. 138 U.S. 252, 253 (1891). The Supreme Court agreed with the defendant and held that the agreement was a license, not an assignment because the plaintiff had received no grant of the right to use the patented item. *Id.* at 257.

[32] *Id.* at 255.

[33] Comment, *supra* note 25, at 100.

[34] 6 T.C. 258 (1946). Myers had invented and patented a rubber covered flexible steel track and had transferred it to B. F. Goodrich Rubber Co. in consideration for annual royalties based on a percentage of sales. *Id.* at 259-61. *See also*, Comment, *supra* note 25, at 100.

[35] *Id.* at 259-60.

and held that these provisions were merely conditions subsequent which did not prevent the passing of legal title. The Court distinguished this transaction from the one involved in *Waterman v. Mackenzie* on the grounds that here transferee's exclusive license included the express authority to use the invention, whereas in *Waterman* this authority had been absent.[36]

Initially, the Commissioner acquiesced, but four years later he revoked this acquiescence and substituted nonacquiescence.[37] Due to the need to resolve the confusion created by the Commissioner's nonacquiescence, and partially because of sympathy for the taxpayer/inventor, Congress enacted section 1235 of the Internal Revenue Code of 1954.[38] The statute eliminates problems associated with the method of payment for the patent and the use of terms inconsistent with the granting of an assignment. Additionally, the legislative history of section 1235 clearly indicates that capital gains treatment will be allowed despite the presence of a clause in the written agreement that the rights to a particular patent may revert to the transferor on the occurrence of a condition subsequent.[39]

Section 1235's provisions as to what constitutes a sale or exchange of a patent read not unlike *Waterman's* requirements, but with one important difference. Section 1235 provides as follows:

> A transfer . . . of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfer are—
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> (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
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> (2) contingent on the productivity, use or disposition of the property transferred.[40]

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[36] *Id.* at 263. *See also*, Comment, *supra* note 25, at 100.

[37] 1946-1 C.B. 3, *nonacq.* 1950-1 C.B. 7, *acq.* 1958-1 C.B. 6.

[38] Comment, *supra* note 25, at 100-01.

[39] *See generally* Notes, *Capital Gains Treatment of Patent Transfers*, 17 W. RES. L. REV. 844 (1966).

[40] I.R.C. § 1235(a). Of course, the transfer cannot be by gift, devise or inheritance. *Id.* Additionally, the holder of the patent must be the individual whose efforts created the property or any other individual who has acquired an interest in such property in exchange for consideration in money or its equivalent prior to the actual reduction to practice of

This section naturally resolved the problem of periodic payments which had rendered a transfer of a patent a mere license not qualifying for capital gains treatment. Not surprisingly, the statute created a new problem. This new problem centers around the definition of what is a sale of "all substantial rights" and the definition of what is a sale of "an undivided interest therein which includes a part of all such rights."

The regulations are helpful in providing a definition for these terms. The regulations define all substantial rights to mean all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred.[41] The term "all substantial rights" to a patent does not include a grant of rights to a patent which:

> (1) is limited geographically within the county of issuance,
> (2) is limited in duration by the terms of the agreement to a period less than the remaining life of the patent,
> (3) grants rights to the grantee in fields or use, within trades, or industries which are less than all the rights covered by the patent which exist and have value at the time of the grant,
> (4) grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.[42]

Rights which are not considered substantial, of course, may be retained by the holder.[43]

Importantly, however, the regulations provide that the circumstances of the whole transaction, rather than the particular language used in the document of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred.[44] The regulations give two examples of rights which

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the invention covered by the patent so long as the person is neither the employer of the creator nor related to the creator. *Id.* § 1235(b), (d).

[41] Treas. Reg. § 1.1235-2 (1957).

[42] *Id.* § 1.1235-2(b)(1)(i)-(iv).

[43] *Id.* § 1.1235-2(b)(2)(i)-(ii). The regulations give two examples of rights which may be retained by the transferor:

> (i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;
> (ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest. . . . , or a reservation in the nature of a condition subsequent. . . .

Id.

[44] *Id.* § 1.1235-2(b)(1).

may or may not be substantial depending upon the circumstances of the whole transaction: (1) the retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;[45] and (2) the failure to convey to the transferee the right to use or to sell the patent property.[46] Of course, the retention of a right to terminate the transfer at will is the retention of a substantial right.[47]

Finally, the regulations provide that a person owns an undivided interest in all substantial rights in a patent when he owns the same fractional share of each and every substantial right to the patent.[48] This does not include, by way of an example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent.[49] Furthermore, a transfer limited in duration to a period less than the remaining life of the patent is not a transfer of an undivided interest in all of the substantial rights to a patent.[50]

In *Eickmeyer v. Commissioner*[51] the Tenth Circuit dealt with the problem delineated above in determining whether there had been a transfer to an "undivided interest," as defined by the Code, in "all substantial rights" to a patent so that the royalties paid to the transferor could receive capital gains treatment.[52]

Eickmeyer developed and patented in 1974 a process which had wide application in the oil refining, petrochemical and fertilizing industries. The process was called the Catacarb process and Eickmeyer was the only record owner.[53]

From January 1, 1960 to December 31, 1970, Eickmeyer entered into twelve separate agreements for the use of the Catacarb process, and during the three years for which the Internal Revenue Service had found a deficiency in Eickmeyer's income taxes, he had received payments pursuant to eight of those agreements.

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[45] *Id.* § 1.1235-2(b)(3)(i).
[46] *Id.* § 1.1235-2(b)(3)(ii).
[47] *Id.* § 1.1235-2(b)(4).
[48] *Id.* § 1.1235-2(c).
[49] *Id.*
[50] *Id.*
[51] 580 F.2d 395 (10th Cir. 1978).
[52] *Id.* at 397-98.
[53] *Id.* at 397.

Eickmeyer claimed that the royalties received from the agreements were eligible for capital gains treatment under section 1235, but the Commissioner disagreed, claiming that not all of the substantial rights to the patent had been transferred.[54]

The Tenth Circuit agreed with the Commissioner. The court noted that even though the percentage of ownership or quantity of ownership need not be the same as that of the transferor, "the character of the right of transfer must be the same. Each element in the title must be present in that which is transferred."[55] The court further noted that in order to receive capital gains treatment there had to have been a sale of an interest in all of the rights which the transferor had in the patent, and that the interest transferred by Eickmeyer fell short of this requirement.[56] The crucial right which Eickmeyer had retained, according to the Tenth Circuit, was the right to collect royalties for all uses of the patent not only from the original transferees, but also from their subassignees or sublicensees.[57] All the substantial rights to the patent had not been transferred by Eickmeyer, the court observed, for if his transferees were to grant a sublicense or subassignment they would only be doing so in behalf of Eickmeyer; the royalties would inevitably be paid to Eickmeyer either by his transferee or the subtransferee.[58] The Tenth Circuit concluded that the practical effect of Eickmeyer's assignment was to grant non-exclusive licenses to each of the transferees and, as each of the transferees remained under the control of Eickmeyer and were not true owners of their respective interests, section 1235 treatment was not available.[59]

Therefore, within the jurisdiction of the Tenth Circuit, the term "undivided interest" contemplates a fractional interest in all of the rights which are part of the ownership of the patent. There is no such transfer when the transferor retains the right to payments or royalties, based on use, from subassignees or sub-

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.* All of the contracts purported to give the assignees of the patent the right to transfer a similar interest to other parties. However this provision was coupled with the requirement that the compensation measured by the extended use of the patent by these subassignees must flow to Eickmeyer.

[58] *Id.* at 400.

[59] *Id.*

transferees, and the original transferees or assignees remain accountable to the transferor.[60]

III. SECTION 337 AND THE PROBLEM OF EXPENSES ARISING FROM THE SALE OF CORPORATE ASSETS: *Benedict Oil Company v. United States.*[61]

Section 337 of the 1954 Internal Revenue Code was enacted in an effort to eliminate an inequitable distinction in tax treatment of certain methods of corporate liquidation.[62] Before the enactment of section 337, if a corporation sold its assets prior to liquidation in an attempt to distribute cash to its stockholders in exchange for their stock, the corporation was still taxed at the corporate level for any gain made on the sale.[63] However, if the corporation chose instead to make an in kind distribution of the assets to the stockholders in exchange for their stock, no gain or loss was recognized to the liquidating corporation, only to the stockholders.[64]

Section 337 eliminated this distinction, which had often resulted in a difference in the net realizable distribution to a shareholder in liquidation, by providing:

> (a) General Rule—If—
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> (1) A corporation adopts a plan of complete liquidation on or after June 22, 1954, and
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> (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.[65]

Therefore, if the requirements of section 337 are met, the corporation recognizes no gain or loss from the sale of its corporate assets.

However, even though no gain or loss is recognized by the corporation under section 337, the corporation would naturally incur expenses, usually in the form of attorney and brokerage

[60] *Id.*

[61] 582 F.2d 544 (10th Cir. 1978).

[62] H.R. REP. No. 1337, 83rd Cong., 2nd Sess. 38-39 A106 (1954), *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4244.

[63] *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

[64] *See, e.g.*, United States v. Cumberland Public Serv. Co., 338 U.S. 451 (1950); *see generally* I.R.C. § 336.

[65] I.R.C. § 337.

fees, while attempting to sell those assets prior to liquidation. In *United States v. Mountain States Mixed Feed Company*[66] the Tenth Circuit, following the only other circuit court decision at that time, *Pridemark Inc. v. Commissioner,*[67] held that legal fees related to the sale of assets during a section 337 liquidation were deductible as an ordinary and necessary business expense under section 162 of the Code.[68]

This ruling, however, was not subsequently followed by any other circuit court.[69] Additionally, the Fourth Circuit reversed its earlier decision in *Pridemark Inc. v. Commissioner,*[70] and joined the view of the other circuits holding that expenses attributable to the sale of assets pursuant to a section 337 liquidation must be offset against the gain from the sale and are not deductible under section 162.[71]

Benedict Oil Company v. Commissioner[72] is an important Tenth Circuit decision in that it overrules *Mountain States Mixed Feed Company,* and brings the Tenth Circuit into accord

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[66] 365 F.2d 244 (10th Cir. 1966).

[67] 345 F.2d 35 (4th Cir. 1965), *rev'd,* Of Course Inc. v. Commissioner, 499 F.2d 754 (4th Cir. 1974).

[68] United States v. Mountain States Mixed Feed Co., 365 F.2d 244, 245 (10th Cir. 1966). The Tenth Circuit's rationale for this holding was expressed as follows:

> It is difficult to determine any reason in the authorities or in the statutes for any distinction as to the type or purpose of the legal work involved. It is probable that the attorneys could account for the time they devoted to the corporate dissolution as compared with the sale of assets, but there is no reason why this sale of assets is not as much a part of the liquidation as the dissolution of the corporation. Certainly if the costs of distribution in kind may be deducted as ordinary expenses, the legal cost of the sale of assets should likewise be deductible. Thus, it is all part of the liquidation-dissolution of the corporate entity.

Id. at 245-46. *See also* Pridemark Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

[69] Page v. Commissioner, 524 F.2d 1149 (9th Cir. 1975); Connery v. United States, 460 F.2d 1130 (3d Cir. 1972); Lanrao Inc. v. United States, 422 F.2d 481 (6th Cir. 1970), *cert. denied,* 398 U.S. 928 (1970); United States v. Morton, 387 F.2d 441 (8th Cir. 1968); Alphaco, Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967).

[70] Pridemark Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'd,* Of Course, Inc. v. Commissioner, 499 F.2d 754 (4th Cir. 1974).

[71] *See generally* cases cited notes 68 and 69 *supra.*

[72] 582 F.2d 544 (10th Cir. 1978). It should be carefully noted that, even though expenses incurred in the selling of corporate assets are no longer deductible as ordinary and necessary expenses, nevertheless expenses, such as accounting or legal fees, attributable to the complete liquidation of the corporation are still deductible. *See, e.g.,* Gravois Planning Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962). Therefore, attorneys and accountants should keep careful records of their time and expenses allocable to the liquidation in order to insure that these items will not be treated as selling expenses.

with the other circuit courts which have decided the same issue. Benedict Oil Company in 1965 adopted a plan of liquidation pursuant to section 337, and successfully met the requirements of the statute.[73] On its last income tax return, relying on *Mountain States Mixed Feed Company,* the corporation deducted as an ordinary and necessary business expense the accounting, legal and brokerage fees attributable to the sale of the assets.[74] The Commissioner disallowed the deduction by stating that the expenses incurred had to be offset against any gain made on the sale.[75]

The Tenth Circuit reversed its prior holding, and upheld the Commissioner's disallowance.[76] In doing so the Tenth Circuit relied not only on the authority established in other jurisdictions, but also upon the traditional rule that costs incurred in the selling of capital assets are capital expenditures which must be offset against the gain made on the sale, not expenses deductible against ordinary income.[77]

The Tenth Circuit further supported its reversal by noting that shareholders, who receive corporate assets in exchange for their stock and then sell the assets, are subject to the rule requir-

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[73] 582 F.2d at 545.

[74] *Id.* at 545-46.

[75] *Id.* at 545.

[76] *Id.* at 546.

[77] *Id.* at 546, 548. *See* Woodward v. Commissioner, 397 U.S. 572 (1970), which reaffirmed this rule by stating:

> Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible. *See* Internal Revenue Code of 1954, § 263. Such expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold. If the expense is capital, it cannot be deducted as "ordinary and necessary," either as a business expense under § 162 of the Code or as an expense of "management, conservation, or maintenance" under § 212.
>
> It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, . . . (footnotes omitted).

582 F.2d at 574-75. Of course if there is a loss on the sale of the capital asset, the expense of selling that asset will increase the amount of loss, the deduction for which must be compiled in accord with Subchapter P of the Internal Revenue Code. *See generally* I.R.C. §§ 1201-1254.

ing the selling expenses to be offset against the gain on the sale. In light of this fact, to follow *Mountain States Mixed Feed Company* would promote a distinction in the tax treatment of these two forms of corporate liquidation, perpetuating a dependence upon good tax advice, and putting a premium on recognizing the problem early, all of which section 337 was designed to eliminate.[78]

IV. The Deductibility of Reserves for Commissions Earned on Deferred Premium Installments: *Western Casualty and Surety Company v. Commissioner.*[79]

Insurance companies, since 1913, have had special taxation treatment due to the policy of the non-taxation, as income, of that part of the premium which the insurance company must place in reserve in order to meet obligations under its policies.[80] *Western Casualty and Surety Company* deals with the sections of the Code that handle these unique and special taxation problems. The opinion of the Tenth Circuit is organized into two distinct sections. The first section deals with the issue of whether Western Casualty was entitled to deduct as an expense commissions on deferred premium installments under section 832 (b)(6). The second section deals with the problem of how to adjust Western Casualty's income in the year of change in the accounting method, an issue which was contingent upon the Tenth Circuit upholding the Commissioner's decision to disallow a deduction of the deferred commissions.[81]

Western Casualty had two basic methods of payment for insurance policies. The method involved in this particular litigation consisted of issuing insurance policies of one year duration, and allowing the premiums to be paid in installments within the policy year.[82] All policies lapsed if there was failure to pay a premium, and nonpayment of the premium installments was an option of the policyholder under the insurance agreement. The portions of the premium which were not paid at the outset with

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[78] 582 F.2d at 548.

[79] 571 F.2d 514 (10th Cir. 1978).

[80] *See e.g.*, Commissioner v. Standard Life and Acc. Ins. Co., 433 U.S. 148, 152-54 (1977); *see generally* I.R.C. §§ 801-844.

[81] 571 F.2d at 515.

[82] *Id.*

this particular type of policy were called "deferred premium installments."[83]

Western Casualty, in its annual National Association of Insurance Commissioners (NAIC) statement, elected to treat its deferred premium installments as though they had been prepaid, but the deferred premiums were not included in the company's income for tax purposes in the year that the policy was sold.[84] Each year, Western Casualty would establish a reserve for deferred premium installments, and a reserve for the aggregate amount of commissions to be paid to the salesmen on these one year insurance policies. However, the salesmen were only paid their proportionate part of the commissions if and when the policyholder paid his installment on the premium. In that event, the reserve for commissions was reduced by the appropriate amount, and the salesmen were paid their respective portion of the total commission on the policy.[85]

It was these reserves for commissions that created the dispute between Western Casualty and the Internal Revenue Service. During the years in question, Western Casualty added the amounts of the reserves for commissions to the commissions actually paid and deducted the entire sum as a business expense. Inasmuch as the policyholders were not obligated to pay the premiums, and could let the insurance lapse if they so desired, the Commissioner and the Tax Court determined that Western Casualty would not be obligated to pay the commissions until the premiums had actually been paid, and, therefore, the deduction of the entire amount constituted an over-deduction to the extent that it included the unpaid commissions on the deferred premium installments.[86]

The Tenth Circuit, relying heavily upon the analysis of the Tax Court, upheld this decision. The applicable taxing statutes were sections 832 and 162.[87] Section 832 (b)(6) defines "expenses

[83] *Id.*

[84] *Id.* Western Casualty also had the option of including these deferred premium installments as they became due.

[85] *Id.* at 516.

[86] *Id.*

[87] *Id.* The tax court also relied on Treas. Reg. § 1.446-1(c)(1)(ii), which provides that a deduction under the accrual method of accounting is not allowable unless all events have occurred which establish the fact of liability giving rise to the deduction. The Tenth

incurred" as all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, which expenses are deductible from income if so allowed by section 832(c). Section 832(c) defines which of the expenses are deductible from ordinary income by the insurance companies, and authorizes their deduction. Section 832(c)(1) permits a deduction for all "ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses)."[88]

The Tenth Circuit accepted the Tax Court's analysis that section 832 expressly incorporated section 162 and its standards.[89] Under section 162 standards, and the rules and regulations applicable to accrual taxpayers, the commissions could not be considered an expense since all events had not occurred, *i.e.*, the paying of the premium by the policyholder, which fixed on the insurance company the obligation to pay the commissions.[90] Additionally, to deduct as an expense commissions earned on premiums when those same premiums have not been included in the income of the taxpayer would cause the taxpayer's method of accounting to fail to reflect the income from which the expense of commissions arose and from which the expense should appropriately be deducted. Hence, the taxpayer's accounting methods distorted his income.[91] Furthermore, the taxpayer's method of accounting violated the general policy of symmetry of income and

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Circuit did not explicitly rely on this regulation, but it did so implicitly by stating that it agreed completely with the Tax Court's analysis. 571 F.2d at 517.

[88] I.R.C. §§ 832(b)(6), 832(c), 832(c)(1). Specifically, these sections read as follows:

> (6) Expenses incurred.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Association of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).
>
> (c) Deductions Allowed.—In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:
>
> (1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses).

[89] 571 F.2d at 517. Treas. Reg. § 1.446-1(c)(1)(ii) is implicitly incorporated in this part of the Tenth Circuit's analysis.

[90] 571 F.2d at 517.

[91] *Id.*

expenses as prescribed by the United States Supreme Court.[92]

Significantly, the Tenth Circuit rejected the contention that all expenses are deductible if they are contained in the annual statement approved by the National Association of Insurance Commissioners. Western Casualty had argued that the presence of unpaid commissions on the annual statement form was enough to render them expenses within the terms of the statute, and deductible without needing to fulfill the requirements of section 162. The Tenth Circuit held that even though some deference may be given the National Association of Insurance Commissioners' form, that form was not absolute, and where it conflicted with the ordinary requirements of section 162, the latter prevailed.[93] This holding, the court observed, was the logical conclusion to be reached by reading sections 832(b)(6) and 832(c) together. As noted previously, 832(b)(6) prohibits deduction of expenses which do not conform to the requirement of 832(c). Section 832(c)(1) allows for deduction of necessary and ordinary business expenses as provided in section 162. To hold that the requirements of section 162 need not be met as long as the expenses were of the type contained in the National Association of Insurance Commissioners' form would, the Tenth Circuit felt, subvert the meaning of section 162.[94]

The second half of the decision dealt with the problem of adjusting the taxpayer's income pursuant to section 481(a).[95] Sec-

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[92] Commissioner v. Standard Life & Acc. Ins. Co., 433 U.S. 148 (1977).

[93] 571 F.2d at 517. *See also* Commissioner v. General Reinsurance Corp., 190 F.2d 148, 151 (2d Cir. 1951), *cert. dismissed*, 342 U.S. 863 (1951); Commissioner v. United States Guarantee Co., 190 F.2d 152 (2d Cir. 1951).

[94] 571 F.2d at 517. *See also* 8 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 44.55 (1970).

[95] 571 F.2d at 518. The text of § 481(a) is as follows:

SEC. 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) General Rule.—In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect to any taxable year to which this section does not apply unless the adjust-

tion 481 provides that if a taxpayer computes his income under a method of accounting different from the method under which the taxable income for the preceding year was calculated, there shall be taken into account, in the year of change, those adjustments necessary to prevent the duplication or omission of amounts of gross income or deductions.[96]

Adjustment was essential in *Western Casualty* in order to prevent the duplication of the deduction of the commissions both in the current year and in later years.[97] The Tenth Circuit gave the Commissioner broad authority to make the required adjustments, and it rejected the contention that section 481 requires an adjustment only for items that would be omitted or duplicated during the year of change in the accounting method.[98] The court stated that section 481 had no limitation on the "amounts being duplicated or omitted for which adjustment is required," and to impose such a limitation would be inconsistent with the intent of Congress which was to prevent items of income and expense from being reported more than once or omitted entirely.[99] The Tenth Circuit also noted that both the Senate and the House legislative history reflected the intention that section 481 adjustments were to be used to prevent duplication or omissions in taxable years after the year of change.[100] Therefore, the Commissioner had the authority to make section 481 adjustments even though the duplications or omissions might not occur for many years after the change in the accounting method.[101]

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ment is attributable to a change in the method of accounting initiated by the taxpayer.

For an excellent discussion of the statute and the problems solved and caused by it, *see* Note, *Problems Arising From Changes in Tax Accounting Methods*, 73 HARV. L. REV. 1564 (1960).

[96] 571 F.2d at 518.

[97] *Id.*

[98] *Id.*

[99] *Id.* at 520 (citing H.R. REP. No. 1337, 83rd Cong., 2d Sess. *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4076, 4303; S. REP. No. 1622, 83rd Cong., 2d Sess. *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4696, 4947).

[100] 571 F.2d at 520, (citing H.R. REP. No. 1337, 83rd Cong., 2d Sess. *reprinted in* [1954] U.S. CODE CONG. & AD NEWS 4017, 4303-04; S. REP. No. 1620, 83rd Cong., 2d Sess. *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4948-49). *See also*, Treas. Reg. § 1.481-2(d), example (1) (1974).

[101] 571 F.2d at 520.