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# INTEGRATING TAX LAW INTO THE BUSINESS LAW CLASSROOM: A CORPORATE "CRADLE TO GRAVE" CASE STUDY

Lucien J. Dhooge*
Cynthia F. Eakin**

The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.[1]

## INTRODUCTION

Death and taxes, it is universally agreed, are the only two things certain in life.[2] Indeed, every aspect of life has tax ramifications. Birth not only brings joy to a child's parents, it provides them with a tax deduction. Most babies are also simultaneously branded with a social security number that, among other functions, serves as a means of identification for national, state and local tax authorities. Upon reaching adulthood, the tax benefits to parents end and there is a new wage earner with a new tax status. The fruits of labor became subject

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[1] RESPECTFULLY QUOTED: DICTIONARY OF QUOTATIONS 336 (Suzy Platt ed., 1993) (quoting Jean Baptiste Colbert). Colbert served as minister of finance to King Louis XIV of France.

[2] The adage equating death and taxes with certainty has been attributed to English journalist Daniel Defoe who stated in 1726 that "[t]hings as certain as death and taxes, can be more firmly believed." OXFORD DICTIONARY OF QUOTATIONS 254 (Elizabeth Knowles ed., 5th ed. 1999). The adage has also been attributed to Benjamin Franklin who stated in 1789 that "[i]n this world nothing can be said to be certain, except death and taxes." *Id.* at 323.

to annual national and state assessments. Income feeds acquisitive instincts, transactions that are, with very few exceptions, subject to taxation. This change in status also motivates most to undertake a life-long quest for methods by which to minimize tax exposure such as home ownership, a wide range of savings, retirement and pension plans, annuities and tax shelters. The decisions to become a spouse or a parent, the most personal of all choices, carry associated tax consequences. The nation utters a collective groan the fifteenth of every April, and one cannot pass a single day without hearing about somebody's plan for tax reform or relief.[3] Even passing from life becomes yet another taxable event. The cessation of physical existence is not enough to save us from the grasping tentacles of the omnipresent taxman.

The ubiquitous character of the taxman also holds true for businesses. The decision to form a business is rife with tax consequences and pitfalls for the unwary. Tax liability may vary depending on the business entity selected by the participants and, in some cases, their timely completion of requisite filings. The methods by which start-up capital and financing are generated will have tax impacts upon the collective business as well as the individual participants. Other taxation issues arising from the formation stage include whether to purchase or lease the business premises, whether to purchase or lease necessary personal property such as equipment and under what circumstances to utilize employees vs. independent contractors. The day-to-day operation of the business also presents numerous tax issues. Examples of such issues include the tax treatment of awards of compensatory, consequential and punitive damages arising from breach of contract and tort actions and fines imposed by governmental regulatory bodies. Furthermore, although differing in methodology, business organizations share with their anthropomorphic counterparts the desire to minimize tax liability. Like some humans, this desire can result in questionable and perhaps illegal activities such as underreporting income or turning a blind eye to less than truthful bookkeeping practices. Finally, the termination of existence for business organizations is also fraught with tax consequences. Priority and liability issues may cloud the dissolution process. The process may become even more complicated if the business' final breaths are taken during a bankruptcy proceeding.

However, taxation is a subject largely missing from many business law and legal environment courses. A number of reasons may be cited to explain this void. Faced with a daunting and ever-increasing list of topics to be covered, instructors face the inevitable and unenviable task of paring down the subject matter and depth of coverage to a manage-

[3] For example, there were 1550 references to taxation in resolutions and bills pending before the 106th session of the U.S. Congress. *See* Library of Cong., Word / Phrase Search, *at* http://www.thomas.loc.gov/cgi-bin/bdquery.html (last visited Sept. 12, 2000).

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able size.[4] Tax issues thus may join the collection of topics that all business law professors have characterized at one time or another as wishing they had more time to cover in class. Also, the idiosyncratic machinations of the Internal Revenue Code may be deemed too complicated for students experiencing their first in-depth exposure to the law. Tax issues may also be dismissed from the business law classroom because of ae belief that adequate coverage will occur in required accounting courses. Furthermore, business law and legal environment textbooks mention taxation only in passing in confluence with other weightier topics, if at all.[5] This dearth of tax coverage is not intended as a criticism of instructors teaching such courses or the textbooks they utilize or to advocate the mandatory inclusion of tax law in the business law curriculum. Rather, it is intended to highlight the dichotomy between a topic that is an unavoidable universal in our personal and business lives and its scant treatment in the business law classroom. From this apparent disconnection came the inspiration for this case study for instructors who wish to include coverage of tax issues in their courses.

The following case study is intended to provide exposure to basic principles of tax law as they relate to topics within the curriculum of an introductory business law or legal environment course. As such, the tax issues raised by the facts of the case study and suggested resolutions for

[4] For example, the legal and ethical environment of business course at the authors' institution is a one semester course described as providing coverage of "court systems and jurisdiction; litigation and other methods of resolving disputes; ethical decision-making; the Constitution and business; lawmaking and regulation by administrative agencies; international law; business organizations; antitrust law; consumer protection; employment law; contract law; and product liability." UNIV. OF THE PAC. CATALOG 142 (1999-2000).

[5] *See* A. JAMES BARNES ET AL., LAW FOR BUSINESS 403-5 (6th ed. 1997) (taxation of business organizations); *see also* MICHAEL BIXBY ET AL., THE LEGAL ENVIRONMENT OF BUSINESS 250 & 262 (2001) (taxation of business organizations); HERBERT M BOHLMAN & MARY JANE DUNDAS, THE LEGAL, ETHICAL AND INTERNATIONAL ENVIRONMENT OF BUSINESS 511-14, 516 & 540 (4th ed. 1998) (taxation of business organizations); HENRY R. CHEESEMAN, BUSINESS LAW: THE LEGAL, ETHICAL AND INTERNATIONAL ENVIRONMENT 928 (3d ed. 1998) (tax sales); HENRY R. CHEESEMAN, CONTEMPORARY BUSINESS LAW 870-71 (3d ed. 2000) (tax sales); KENNETH W. CLARKSON ET AL., WEST'S BUSINESS LAW 617, 621, 643-44, 711-12 & 967 (8th ed. 2001) (taxation of business organizations and estates); MARIANNE M. JENNINGS, BUSINESS: ITS LEGAL, ETHICAL AND GLOBAL ENVIRONMENT (6th ed. 2002) (wage taxes for independent contractors; business organizations; real property taxes; tax evasion and penalties; international business taxation; social security taxes); NANCY K. KUBASEK ET AL., THE LEGAL ENVIRONMENT OF BUSINESS: A CRITICAL THINKING APPROACH 571 (2d ed. 1999) (international taxation); JANE P. MALLOR ET AL., BUSINESS LAW AND THE REGULATORY ENVIRONMENT 469, 824 & 1178-79 (10th ed. 1998) (tax sales, taxation of foreign and alien corporations and tax havens); ROGER L. MILLER & FRANK B. CROSS, THE LEGAL ENVIRONMENT TODAY: BUSINESS IN ITS ETHICAL, REGULATORY AND INTERNATIONAL SETTING 370-81 & 403-4 (1996) (taxation of business organizations and employment).

these issues are not intended to be comprehensive. Rather, the scope of coverage is modeled to fit with topics common to introductory business law courses and textbooks. Although there is no universal definition of the topics to be discussed in an introductory business law or legal environment course, there is at least consensus as to some of these topics given the commonality of their coverage in textbooks utilized in such courses. These topics include sources of law,[6] the substantive laws of torts, contracts and property,[7] agency and business formation,[8] regulatory limitations upon business activities,[9] ethics[10] and interna-

[6] *See* BARNES, *supra* note 5, at 3-24; *see also* BIXBY, *supra* note 5, at 1-149; BOHLMAN & DUNDAS, *supra* note 5, at 2-28 & 53-166; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 1-56; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 1-32; HENRY R. CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT: CONTEMPORARY PERSPECTIVES IN BUSINESS 1-18 & 97-118 (2d ed. 2000); CLARKSON, *supra* note 5, at 2-25; JENNINGS, *supra* note 5, at 11-33; KUBASEK, *supra* note 5, at 16-31 & 62-138; MALLOR, *supra* note 5, at 2-57; TONY MCADAMS & LAURA PINCUS, LEGAL ENVIRONMENT OF BUSINESS: ETHICAL AND PUBLIC POLICY CONTEXTS 48-99 (1997); MILLER & CROSS, *supra* note 5, at 60-176; DANIEL M. WARNER, THE LEGAL ENVIRONMENT OF BUSINESS 2-141 (1998); DOUGLAS WHITMAN & JOHN W. GERGACZ, LEGAL STUDIES IN BUSINESS 2-157 (1997).

[7] *See* BARNES, *supra* note 5, at 77-256 & 531-646; *see also* BIXBY, *supra* note 5, at 308-456; BOHLMAN & DUNDAS, *supra* note 5, at 194-305 & 439-67; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 75-97 & 158-282; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 83-109, 186-306 & 842-92; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 119-50 & 244-80; CLARKSON, *supra* note 5, at 86-109, 197-328 & 865-930; JENNINGS, *supra* note 5, at 362-403 & 487-632; KUBASEK, *supra* note 5, at 189-313; MALLOR, *supra* note 5, at 107-351 & 434-533; MCADAMS & PINCUS, *supra* note 6, at 133-214 & 516-77; MILLER & CROSS, *supra* note 5, at 177-234, 265-328 & 525-53; WARNER, *supra* note 6, at 174-259; WHITMAN & GERGACZ, *supra* note 6, at 186-277.

[8] *See* BARNES, *supra* note 5, at 333-530; *see also* BIXBY, *supra* note 5, at 221-86; BOHLMAN & DUNDAS, *supra* note 5, at 468-551; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 504-721; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 522-718; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 315-93 & 428-60; CLARKSON, *supra* note 5, at 615-758; JENNINGS, *supra* note 5, at 681-720 & 819-63; KUBASEK, *supra* note 5, at 314-62; MALLOR, *supra* note 5, at 706-991; MCADAMS & PINCUS, *supra* note 6, at 100-32; MILLER & CROSS, *supra* note 5, at 365-400; WARNER, *supra* note 6, at 260-311; WHITMAN & GERGACZ, *supra* note 6, at 278-357.

[9] *See* BARNES, *supra* note 5, at 805-77; *see also* BIXBY, *supra* note 5, at 288-307 & 457-526; BOHLMAN & DUNDAS, *supra* note 5, at 552-695; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 793-897; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 719-841; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 513-633; CLARKSON, *supra* note 5, at 803-64; JENNINGS, supra note 5, at 204-44; KUBASEK, *supra* note 5, at 365-614; MALLOR, *supra* note 5, at 992-1153; MCADAMS & PINCUS, *supra* note 6, at 331-515 & 578-616; MILLER & CROSS, *supra* note 5, at 473-610; WARNER, *supra* note 6, at 312-539; WHITMAN & GERGACZ, *supra* note 6, at 380-477.

[10] *See* BARNES, *supra* note 5, at 46-64; *see also* BIXBY, *supra* note 5, at 189-220; BOHLMAN & DUNDAS, *supra* note 5, at 29-52; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 143-57; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 33-50; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 19-40; CLARKSON, *supra* note 5, at 738-58; JENNINGS, *supra* note 5, at 34-75; KUBASEK, *supra* note 5, at 171-86; MALLOR, *supra* note 5, at 58-77; MCADAMS & PINCUS, *supra* note 6, at

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tional considerations.[11] Utilizing this common framework, the case study examines tax issues associated with agency, business formation and dissolution, property, contracts, torts, environmental law and creditor-debtor relations. Although designed with undergraduate business law and legal environment students in mind, the case study may be adapted as deemed appropriate by the instructor for use in upper division law courses and at the graduate level. Furthermore, after presenting the overall factual background, the instructor may choose only to emphasize select topics discussed within the case study.

A single all-encompassing fact pattern was selected to provide continuity to students and the instructor by allowing them to follow the travails and potential tax pitfalls of a single company throughout the semester. Thus, the case study addresses tax considerations that may arise as a result of the formation, operation and dissolution of a family-owned dry cleaning business in the San Francisco Bay area. Dry cleaning was selected as a suitable example due to the generally small size and limited nature of the operations of such businesses, their proliferation in communities of all sizes and resultant familiarity of students with such businesses. While raising interesting tax questions, utilization of a large national or multinational corporation may go beyond the experience of typical undergraduate business law students and undoubtedly goes well beyond the necessary scope of tax coverage in introductory law courses and the limited intent of this case study.

The case study initially sets forth the factual background underlying the decision to form and operate the dry cleaning business. The case study then examines tax issues that may arise as a result of the decision to form a small business, including choice of entity, the purchase or lease of real and personal property and the employee-independent contractor dilemma. The case study then examines tax issues that may arise as a result of operation of the business. These issues include the tax ramifications of breach of contract actions, the commission of torts and the imposition of fines in the context of environmental regulation. Finally, the case study addresses tax questions associated with the cessation of business operations including dissolution, bankruptcy, underreporting of income and tax evasion.

2-47; MILLER & CROSS, *supra* note 5, at 33-59; WARNER, *supra* note 6, at 142-73; WHITMAN & GERGACZ, *supra* note 6, at 158-85.

[11] *See* BARNES, *supra* note 5, at 878-99; *see also* BIXBY, *supra* note 5, at 150-88; BOHLMAN & DUNDAS, *supra* note 5, at 347-80; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 164-85; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 57-74; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 73-96; CLARKSON, *supra* note 5, at 989-1007; JENNINGS, *supra* note 5, at 246-76; KUBASEK, *supra* note 5, at 32-61; MALLOR, *supra* note 5, at 1154-83; MCADAMS & PINCUS, *supra* note 6, at 617-64; MILLER & CROSS, *supra* note 5, at 611-66; WHITMAN & GERGACZ, *supra* note 6, at 478-92.

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Each topic discussed in the case study contains four sections. The first section consists of a recitation of facts underlying each topic. Although subject to further elaboration at the instructor's discretion, the facts set forth at the beginning of each topic are limited to those necessary to foster a basic understanding of the issues and choices confronting the business and its owners. The second section of each topic sets forth objectives that the instructor may strive to achieve in his or her teaching of the case. The third section consists of questions designed to elicit class discussion and coincide with the stated teaching objectives for the topic. The final section of each topic provides answers to the discussion questions with applicable statutory and case citations.

## FACTUAL BACKGROUND

Martin and Philip Van Gend are brothers living in the San Francisco Bay area.[12] At forty-two years of age, Martin is the older brother and is the owner of a successful commercial real estate development company in Danville, an affluent suburb located thirty miles east of San Francisco. Martin attended Sycamore Valley High School near the family's home in Danville where he graduated as class valedictorian and founded the school's business club. Martin was subsequently accepted as an undergraduate student at the business school at the University of California in Berkeley. Martin excelled in his studies at Berkeley as evidenced by his receipt of numerous academic achievement awards and scholarships. Although interested in many areas of the business school curriculum, Martin was most interested in real estate and finance and concentrated his studies in these areas. Martin graduated with highest honors from the University of California with a bachelor of science degree in business.

Upon completion of his undergraduate studies, Martin was hired to work in the commercial real estate department of California First Federal Savings Association in San Francisco. Martin also attended a preparatory course for the California real estate sales examination. Martin successfully completed the examination and earned his sales license. Martin subsequently accepted a position as a salesperson with a large commercial land developer in San Francisco. Martin rapidly rose through the ranks, ultimately becoming the vice-president of the leasing and property management departments after only five years at the company. During this time, Martin earned his real estate brokerage license from the state of California. Martin also returned to the University of California seven years after the completion of his

[12] All names and facts are fictional. Similarities with actual people and events are merely coincidental. The case study is based upon events occurring in the San Francisco Bay area but may be adapted to the instructor's own environs.

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undergraduate studies to earn a master of business administration degree.

Upon completion of his master's degree, Martin left his employment to open his own commercial real estate development business in the East Bay. Martin formed Van Gend Development, Inc. (VGD), a California corporation headquartered in Danville, to acquire and develop real estate for commercial use in northern California. Acting on its own and in conjunction with other real estate investment entities, VGD has been very successful and has become one of the largest development firms in the Bay Area. This success has allowed VGD to diversify its activities into other areas, including lease brokerage and property management services. In fact, revenues derived by VGD from its lease brokerage and property management services are the company's fastest growing income sources. VGD's success has made Martin wealthy and given him a highly visible place in the Bay Area business community.

At twenty-eight years of age, Philip is the younger of the Van Gend brothers. Unlike Martin, Philip's educational path has been inconsistent. Philip attended Sycamore Valley High School but demonstrated far less interest in academics than his brother. Although he graduated from high school, Philip's grades prevented him from gaining admission to any of the premier colleges and universities located in the Bay Area. In any event, Philip demonstrated little interest in attending a four-year institution. Philip did enroll in the associate degree program at Diablo Valley Community College in Pleasant Hill, California two years after graduating from high school but completed only one year of the program and never earned a degree.

Philip's career path has been equally inconsistent. Philip began working at a local pizzeria as a sophomore in high school. Philip started out as a dishwasher and busser with subsequent promotions to waiter, cashier and assistant manager by his senior year of high school. Philip continued to manage the pizzeria for three years after graduation until leaving to accept a position as a management trainee at a new restaurant to be opened by a national chain in Pleasant Hill. Philip completed the company's management training program and accepted a position as an assistant manager with the company. Philip worked as an assistant manager at the restaurant for two years until he resigned due to low pay, long hours and inadequate opportunities for advancement within the company. Philip has worked at four other local restaurants in the last five years but has never been able to advance beyond the position of assistant manager. As a result, Philip does have some practical experience in the management and operation of a business, but he has no formal business training, has never worked outside the restaurant industry and has never owned or operated his own business.

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Philip has increasingly expressed frustration with this state of affairs and his desire to manage a business to Martin. For his part, Martin has expressed concern that Philip is wasting time in a dead end career with little to show for his efforts, is developing a reputation as an unreliable worker and ruining his future ability to find work by developing an inconsistent work history. As a result, Martin has offered to provide financial assistance to Philip to establish a business. Martin has expressed his unwillingness to invest in the restaurant industry due to the proliferation of national chains operating in the area and resultant high degree of risk. After much discussion, Martin agreed to assist Philip in the establishment of a dry cleaning business in a strip shopping center in Danville. Martin and Philip agreed upon a dry cleaning business due to the lack of a reliable cleaner in Danville, the small amount of real property needed to conduct such operations and the relatively low risk in comparison to other lines of business.[13]

## TAXATION ISSUES IN BUSINESS FORMATION

### *Factual Background*

Upon reaching the decision to establish Philip in the dry cleaning business, the Van Gend brothers undertook numerous activities. Initially, the brothers debated what form of entity to establish for purposes of operating the business. After considering and rejecting the general partnership, limited partnership and limited liability company forms of business, the brothers formed Dutch Boy Cleaners, Inc. (DBC) pursuant to the corporation code of the state of California. Stock ownership in the new entity was divided equally between Philip and Martin with both brothers serving on the initial board of directors. Furthermore, the incorporation documentation identified Martin as the president with Philip serving as secretary-treasurer.

Martin and Philip also reached a detailed agreement concerning the initial capitalization of DBC. Specifically, they agreed that Martin's contribution to the business would be the vast majority of the startup capital. Philip's contribution to the business was a small amount of startup money as well as past services rendered relating to researching all aspects of operating a dry cleaning business. Although the monetary

[13] Additional information regarding the startup and operation of a dry cleaning business may be obtained from a wide variety of sources. *See generally* Texchine, Inc., *How to Start Your Own Dry Cleaning Business, at* http://www.mindspring.com/jimgirone/cleanpage/howto.html (last visited June 8, 2001); *see also* Jonathan H. Adler, *Taken to the Cleaners: A Case Study of the Overregulation of American Small Business,* Cato Inst., *at* http://www.cato.org/pubs/pas/pa-200.html (Dec. 22, 1993) (emphasizing the negative aspects of entry into the dry cleaning industry); Nate Marks & Debra Luhring, *How Dry Cleaning Works, at* http://www.howstuffworks.com/dry-cleaning.htm (last visited June 8, 2001) (providing a understandable summary of the dry cleaning process).

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value of Martin's contribution to the capitalization of DBC greatly exceeded that of Philip, the brothers agreed that they would be equal owners of the business. This valuation of Philip's contribution and the brothers' agreement on ownership were subsequently confirmed in a duly issued DBC corporate resolution.

Martin contacted the owners of strip malls in the Danville area for purposes of finding a suitable location for DBC's business. After several contacts, Martin reached an agreement with Sycamore Valley Partners (SVP), a California general partnership that owned and operated the Danville Commons Shopping Center. Upon securing Philip's consent, Martin immediately entered into negotiations with SVP. These negotiations resulted in the execution of a real property lease for space within the Danville Commons Shopping Center for a term of five years. The lease called for the completion of extensive modifications of the premises by the landlord with the lease commencing upon the completion of minor improvements to be made by DBC. DBC's payment of base rent to SVP was net of taxes, insurance and maintenance costs, which were to be charged separately to DBC based upon its proportionate share of the usable square footage of the shopping center.

As a further contribution to the start-up of the business, Martin contacted numerous manufacturers and distributors of dry cleaning equipment. With Philip's consent, Martin ultimately selected Clean-Pro Equipment, Inc. (CPE), a California corporation, as the supplier of the dry cleaning equipment to DBC. After much discussion and consultation with CPE representatives, Martin and Philip determined that DBC would require two motor-driven washer/extractor/dryers, each with a one hundred-pound capacity and appropriate pump and filtration systems, and three washing machines and dryers for materials to be laundered without dry cleaning. Furthermore, it was determined that DBC required one general purpose pressing machine and one special pressing machine for shirts. Martin and Philip decided that DBC would lease this equipment from CPE with the option to purchase the equipment within three years of the lease commencement date. DBC also leased a computer system to be utilized for clothing tracking, customer identification and billing purposes. Other miscellaneous property to be used in the operation of the business, including laundry bags, clothing tags, cleaning solvents and emulsifiers, was to be purchased by DBC.

The final formation issue concerned the number of people to be hired to operate the business and the nature of their status. Martin and Philip decided to hire seven people full-time and two people part-time. Martin and Philip contemplated four workers being present on the premises at any one time with one person operating the washer/extractor/dryers, one person operating the washing machines

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and two people operating the pressing machines. In addition, Philip agreed to be on the premises or on call as needed. It was determined that these persons would be hired on an at-will basis as DBC employees subject to company control with one exception. Specifically, DBC decided to hire Will Harms as an independent contractor to drive a delivery van donated to the company by Martin for use in its mobile dry cleaning pickup and delivery service. Martin and Philip decided to hire Harms as an independent contractor due to the uncertainty of the success of the mobile service. It was intended that Harms' position would be converted into a full-time employee position if DBC's mobile service proved successful.

*Teaching Objectives*

There are three teaching objectives with respect to this portion of the case study. Initially, class discussions may explore the tax consequences relating to choice of business entity. Two specific tax aspects of this choice may be examined. Initially, class discussions may focus on the differing tax treatment afforded to each of these entities by the Internal Revenue Service. This topic is generally covered in some detail in the surveyed business law and legal environment textbooks.[14] Hence, the instructor may choose to use this portion of the case study as review of these concepts or to focus upon necessary procedural or filing requirements. Second, the instructor may use this portion of the case study to examine the personal financial and tax ramifications of choice of entity issues for individuals participating in such entities. This is a topic that is covered in less detail in the surveyed textbooks.[15] In this regard, the instructor may examine the capitalization of such entities through financial and service contributions.

[14] *See* BARNES, *supra* note 5, at 403-5; *see also* BIXBY, *supra* note 5, at 250 & 262; BOHLMAN & DUNDAS, *supra* note 5, at 499, 511-16 & 540; CLARKSON, *supra* note 5, at 722-23; KUBASEK, *supra* note 5, at 340-41; MALLOR, *supra* note 5, at 745-48, 820 & 824; MCADAMS & PINCUS, *supra* note 6, at 103-9; MILLER & CROSS, *supra* note 5, at 366 & 369-72; WARNER, *supra* note 6, at 280, 284, 287, 289 & 302-3.

[15] Coverage of the personal financial ramifications of choice of entity issues is limited to discussion of financing of unincorporated associations and corporations and liability arising from participation in such entities. *See* BARNES, *supra* note 5, at 400-10, 424-25, 433 & 476-81; *see also* BIXBY, *supra* note 5, at 246-50 & 277-78; BOHLMAN & DUNDAS, *supra* note 5, at 498, 504, 510 & 528-33; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 560, 574-79, 586 & 615-20; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 554, 578, 585-87, 593-94 & 621-25; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 317, 320, 327 & 359-61; CLARKSON, *supra* note 5, at 616-20, 651-54 & 717; KUBASEK, *supra* note 5, at 335-37 & 342-45; MALLOR, *supra* note 5, at 744-48 & 845-53; MCADAMS & PINCUS, *supra* note 6, at 103-8; MILLER & CROSS, *supra* note 5, at 366-72; WARNER, *supra* note 6, at 280, 283, 285-86, 288 & 291-92; WHITMAN & GERGACZ, *supra* note 6, at 328-42. However, see JENNINGS, *supra* note 5, at 836 & 839.

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Class discussions may also focus on the tax consequences associated with the lease of real property and the decision whether to purchase or lease personal property to be utilized in the operation of a business. Although real and personal property leases are discussed in several of the surveyed textbooks, none of these texts address the related tax aspects or the role such tax aspects play in the decision whether to lease or purchase business property.[16] From a real property standpoint, class discussions may focus on the tax treatment of various items within most commercial lease payments such as base and percentage rent, insurance, operating expenses and common area maintenance fees. From a personal property standpoint, the instructor may focus upon the differing tax treatment of purchased and leased property and the deductibility of lease payments and finance charges.

Finally, class discussions may examine three tax aspects of the decision whether to use employees or independent contractors in the operation of the business. The first aspect to be examined relates to the differences between employees and independent contractors with respect to tax treatment. Business law and legal environment textbooks that discuss this topic focus primarily on the obligation of the independent contractor to pay his or her taxes from lump sum distributions received from the employer.[17] However, there are numerous other differences worthy of mention such as differences in eligibility for fringe benefit and insurance programs, treatment of unreimbursed business expenses and liability for self-employment tax.[18] The second aspect to be examined relates to the complex test used by the Internal Revenue Service to determine whether one providing services on behalf of

[16] *See* BARNES, *supra* note 5, at 591-606 (real property leases); *see also* BIXBY, *supra* note 5, at 416-18 (real property leases); BOHLMAN & DUNDAS, *supra* note 5, at 445-46 (real property leases); CHEESEMAN, BUSINESS LAW, *supra* note 5, at 286-88 & 939-48 (personal and real property leases); CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 311-17 & 876-82 (personal and real property leases); CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 264-65 (personal property leases); CLARKSON, *supra* note 5, at 907-20 (real property leases); JENNINGS, *supra* note 5, at 598-632; KUBASEK, *supra* note 5, at 290 (real property leases); MALLOR, *supra* note 5, at 493-508 (real property leases); MCADAMS & PINCUS, *supra* note 6, at 175-88 (real property leases); MILLER & CROSS, *supra* note 5, at 534-39 (real property leases); WHITMAN & GERGACZ, *supra* note 6, at 180 (real property leases).

[17] *See* BOHLMAN & DUNDAS, *supra* note 5, at 486-87; *see also* CLARKSON, *supra* note 5, at 573; MILLER & CROSS, *supra* note 5, at 404. *But see* JENNINGS, *supra* note 5, at 742.

[18] For example, although independent contractors are permitted to deduct unreimbursed business expenses in full, they must pay their own share of FICA and medical health insurance taxes. *See* I.R.C. §§ 1401(a) & (b) & 1402(a) (2000). Independent contractors also relinquish many fringe benefits enjoyed by employees such as employer-provided health insurance, meals and lodging, cafeteria plans and employee discounts. *See id.* §§ 106(a), 119(a)(1) & (2), 125(d)(1)(A) & 132 (c)(1); *see also infra* notes 65-72 and accompanying text.

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another is an employee or an independent contractor.[19] The applicable tests for determining such status set forth in the surveyed textbooks are often a compilation of state law guidelines utilized primarily to determine the liability of a principal for the tortious misconduct of its agents.[20] However, it is important to note that these guidelines differ from those used by the Internal Revenue Service, which are more comprehensive and considerably more detailed.[21] Finally, class discussions on this subject may be used to examine the increasing reliance of businesses upon independent contractors. The instructor may choose to examine the perils to a business in the event that classification of its independent contractors is disallowed and such persons are reclassified as employees.[22]

[19] *See* Rev. Rul. 87-41, 187-1 C.B. 296; *see also* Treas. Reg. § 31.3121(d)-1(c)(1-3) (as amended in 1980); Treas. Reg. § 31.3306(i)-1(b) (1960); Treas. Reg. § 31.3401(c)-1(b) (as amended in 1970).

[20] *See* BARNES, *supra* note 5, at 367 (control and ability to set prices and determine profits, losses and work schedule); *see also* BIXBY, *supra* note 5, at 225 (control, ownership of tools, method of payment, length of relationship and freedom to work for others); BOHLMAN & DUNDAS, *supra* note 5, at 486 (control, ownership of tools, method of payment, withholding for taxes, length of relationship and type of job and skill required); CHEESEMAN, BUSINESS LAW, *supra* note 5, at 507 (control, ownership of tools, method of payment, length of relationship, type of job and skill required and the right to retain subagents); CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 525 (control, ownership of tools, method of payment, length of relationship, type of job and skill required and the right to retain subagents); CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 431 (control, ownership of tools, method of payment, length of relationship, type of job and skill required and right to retain subagents); CLARKSON, *supra* note 5, at 573-74 (control, ownership of tools, method of payment, length of relationship and type of job and skill required); KUBASEK, *supra* note 5, at 316-17 (control, ownership of tools, method of payment, length of relationship and type of job and skill required); MALLOR, *supra* note 5, at 710-11(control, length of relationship, method of payment, ability to determine profits and losses, type of job and skill required and existence and nature of investment in the business); MCADAMS & PINCUS, *supra* note 6, at 256 (control, method of payment, ability to determine profits and losses and right to retain subagents); WARNER, *supra* note 6, at 262 (control); WHITMAN & GERGACZ, *supra* note 6, at 306 (control, ability to determine schedule and freedom to work for others). Two of the cited textbooks make explicit reference to the Internal Revenue Service's employee-independent contractor guidelines. *See* JENNINGS, *supra* note 5, at 742; *see also* MILLER & CROSS, *supra* note 5, at 404.

[21] *See* Rev. Ruling 87-41, 1987 C.B. 296. For a complete discussion of the twenty-factor test, *see infra* note 73 and accompanying text.

[22] For example, firms and other parties responsible for withholding taxes may be assessed the employer's share of payroll taxes as well as interest and penalties in the event an independent contractor is reclassified as an employee by the Internal Revenue Service. *See* I.R.C. §§ 3403 & 6672(a) (2000); *see also infra* notes 81-84 and accompanying text.

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*Questions for Discussion*

1. How is each of the entities identified by the Van Gend brothers as potential forms for their dry cleaning business treated for purposes of taxation? What limitations and requirements, if any, are imposed upon such entities to qualify for such tax treatment?
2. How are such entities initially capitalized? What taxation issues may arise from capitalization of these business entities? How should contributions to capitalization be treated for taxation purposes? Should such contributions be treated the same or differently for taxation purposes? What are the reasons for your answer?
3. What expenses incurred by commercial landlords are passed through to their tenants? As these charges are expenses of doing business for commercial tenants, should they be able to be deducted from such tenants' income tax returns? What are the reasons for your answer?
4. Should Philip and Martin purchase or lease the equipment to be used in their dry cleaning operation? How are purchased and leased personal property treated for tax purposes? If Philip and Martin purchase the personal property to be used in the business on credit, should they be able to deduct their installment payments and finance charges as business expenses? Why or why not? If Philip and Martin lease such personal property, should they be permitted to deduct their lease payments as business expenses? Why or why not? Does the differing tax treatment of purchased and leased property change your initial answer on which course of action the Van Gend brothers should pursue?
5. Should the Van Gend brothers hire employees or use independent contractors for the operation of their business? What are the characteristics of the employer-employee and employer-independent contractor relationship? What are the advantages and disadvantages of each of these relationships? What are the tax treatment differences between employees and independent contractors? What factors are relevant in determining whether a person is an employee or an independent contractor? What are the risks to Philip and Martin as well as the people they hire in the event that they determine to use independent contractors to operate the business?

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*Answers to the Discussion Questions*

*Question Number 1*

The principal legal forms of business entities involving two or more persons are corporations, general and limited partnerships and limited liability companies. From a tax standpoint, there are two types of corporations. Governed by Subchapter C of the Internal Revenue Code, a C corporation is a separate taxable entity.[23] The structure of the C corporation contemplates a two-tier system of taxation consisting of the corporation itself and its shareholders. This two-tier system has been aptly described as resulting in shareholder recognition of "gain on corporate distributions . . . (usually as dividends) . . . even though the amounts distributed represent earnings that have been taxed to the corporation."[24]

Conversely, taxation of an S corporation more closely resembles that of a partnership. Profits and losses are not taxed at the corporate level, but rather, are passed through to the shareholders who are solely responsible for the payment of tax.[25] However, there are several requirements that must be satisfied to qualify for S treatment, including a cap upon the number of shareholders at seventy-five, prohibitions upon non-natural persons and nonresident aliens as shareholders and the existence of no more than one class of stock.[26] Furthermore, a corporation seeking S treatment must file an election of such status with the Internal Revenue Service.[27] In order to be effective for a current tax year, the election must be made during the previous taxable year or before the fifteenth day of the third month of the current taxable year.[28] A notice failing to comply with these deadlines is treated as an election for the following tax year.[29]

Unincorporated associations are not separate taxable entities. Rather, like shareholders of a Subchapter S corporation, partners or members of a general or limited partnership or limited liability company report their share of net profit or loss on their respective individual tax returns.[30] The Internal Revenue Service issued so-called "check the box" regulations in 1996 that permit most unincorporated associations to elect whether to be taxed as an association or as a

[23] *See* I.R.C. § 7701(a)(1) (2000).
[24] JACOB MERTEN, THE LAW OF FEDERAL INCOME TAXATION § 41B.239 (Supp. 1998).
[25] *See* I.R.C. § 1366 (a)(1)(A) & (B) (2000).
[26] *See id.* §§ 1361(b)(1)(A-D) & (c)(2)(A)(i-v).
[27] *See id.* § 1362(a)(1) (1994).
[28] *See id.* § 1362(b)(1)(A) & (B).
[29] *See id.* § 1362(b)(2)(A) & (B).
[30] *See id.* §§ 702(a)(1-8) & 704(a).

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partnership for tax years beginning after 1996.[31] These regulations replaced the previous requirement that the unincorporated association more closely resemble a partnership than a corporation in term, management, liability and transferability in order to obtain favorable tax treatment.

*Question Number 2*

Initial capitalization of the above-referenced entities occurs through contributions made by the participants in exchange for an ownership stake in the business. These contributions may consist of money, property or services. Transfers of property to a corporation or a partnership in exchange for stock or an ownership interest have significant tax consequences. The Internal Revenue Code provides for nonrecognition of gain or loss when property is transferred to a corporation in exchange for stock[32] or a partnership in exchange for an ownership interest.[33] To qualify for such nonrecognition, the property must actually be transferred to the entity in exchange for an ownership interest and, in the case of corporations, the transferors must be in control of the entity immediately after the transfer, either as individuals or as a group.[34] "Control" is defined as the ownership of stock possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock of the corporation.[35]

The Van Gend brothers may have failed to achieve a tax-free incorporation based upon the facts set forth above. Although Martin and Philip together own more than eighty percent of the outstanding stock of DBC, Philip may not have contributed sufficient property to the corporation. Philip's minimal contribution of money in return for a substantial ownership interest may be insufficient to count as property for purposes of determining control and, ultimately, the tax-free nature of the incorporation.[36] This is especially true if the primary purpose of the contribution is to qualify exchanges of property by other persons for tax-free treatment.[37] Additionally, Philip's contribution of past services in return for stock will not count as property for purposes of determining control.[38] Thus, Philip's share of the stock may not count for

[31] *See* Treas. Reg. § 301.7701-2(b) (as amended in 1999); *see also* Treas. Reg. § 301.7701-3(a) (as amended in 1999).

[32] *See* I.R.C. § 351(a) (1994).

[33] *See id.* § 721(a).

[34] *See id.* § 351(a).

[35] *See id.* § 368(c).

[36] *See* Treas. Reg. § 1.351-1(a)(1)(ii) (as amended in 1996).

[37] *See id.*

[38] *See* Treas. Reg. § 1.351-1(a)(1)(i) (as amended in 1996). This non-recognition of past services as property for tax purposes is particularly important given the recognition of

purposes of determining control. Although Martin did contribute property to DBC, specifically, money and the delivery van to be utilized in the company's mobile laundry service, he owned less than eighty percent of the outstanding voting stock immediately after the transfer. Thus, Martin is not in control of the business as required for transfers of property to be tax-free pursuant to the Internal Revenue Code. As such, Martin will be taxed on the property he contributed to DBC. The amount of the tax will be based upon the difference between Martin's basis in the property and its fair value at the time it was exchanged for the DBC stock. This taxation could have been avoided had Martin and Philip both contributed sufficient property to the business. In such event, they could have combined their ownership, thereby meeting the Internal Revenue Code's requirement of control. In such circumstances, the incorporation would have been tax-free to both brothers.

Initial capitalization may also occur, in part, through loans extended to the corporation. There are important differences between debt and equity in the capitalization of a corporation. Initially, interest paid to creditors is deductible by the corporation as an ordinary and necessary business expense.[39] By contrast, dividends paid to shareholders as a return on capital investments are not viewed as business expenses but as distributions of property made out of corporate earnings and profits.[40] Thus, dividends are not deductible by the corporation and are taxable to the shareholder.[41] Another important difference is that repayment of the principal amount loaned to a corporation is not income to the shareholder making the loan. It is simply a return of the original amount loaned. By contrast, shareholder withdrawals of investments in corporate stock are not generally tax-free. As long as a corporation is profitable, all such distributions to shareholders are viewed as coming from profits[42] and are taxable as ordinary income.[43] The withdrawal is not taxable if the firm has insufficient earnings and profits and the distribution is viewed as a return of the shareholder's initial capital contribution.[44]

These differences create interesting tax planning opportunities for incorporating parties. For example, if an incorporating party makes a contribution in return for corporate stock, any subsequent distribution may be taxable as dividend income or a withdrawal of a capital

such services as valid consideration for the issuance of corporate stock. *See generally* 18A AM. JUR. 2D *Corporations* § 499 (1985); *see also* 15 CAL. JUR. 3D (Rev.) *Corporations* § 141 (1983).

[39] *See* I.R.C. § 163(a) (2000).

[40] *See id.* § 316(a).

[41] *See id.* § 301(c)(1).

[42] *See id.* § 316(a).

[43] *See id.* § 301(c)(1).

[44] *See id.* § 301(c)(2).

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contribution. Alternatively, the incorporating party could designate a portion of such contribution as an interest-bearing loan with periodic repayment of principal. In such instance, only interest payments and dividend distributions would be taxable. The corporation would be allowed to deduct the interest payment and, at the end of the loan term, the principal will have been returned to the incorporating party tax-free.

Given these advantages, it is tempting to structure most capital contributions as long-term debt. However, incorporating parties should be wary of the "thin capitalization" problem. Thin capitalization occurs when shareholder debt is high relative to shareholder equity. If the Internal Revenue Service determines the corporation to be thinly capitalized, it has the ability to reclassify the debt as equity in whole or in part.[45] If the debt is reclassified as equity, the principal and interest payments are considered to be dividends.[46] Although the Internal Revenue Service is empowered to reclassify debt,[47] previous regulations issued by the Treasury Department and containing specific guidelines for determining when debt should be reclassified were withdrawn in 1983 and have not been reissued.[48] As such, taxpayers must rely upon factors listed in the Internal Revenue Code[49] and established by judicial interpretation.[50] In any event, the burden of demonstrating that the

[45] *See id.* § 385(c)(1).

[46] *See id.*

[47] *See id.* § 385(a).

[48] *See* Treas. Reg. § 1.385-1-10 (1980) (withdrawn by T.D. 7920, 1983-2 C.B. 69).

[49] *See* I.R.C. § 385(b)(1-5) (2000). The factors listed in the Code focus on the following: (1) the existence of an unconditional promise to pay on demand or on a specified date a sum certain and a fixed rate of interest; (2) the subordination to or preference over any existing corporate indebtedness; (3) the ratio of corporate debt to equity; (4) whether the debt is convertible into corporate stock; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question. *See id.*

[50] The cases distinguish between creditors and shareholders by noting that creditors seek repayment of a definite obligation that is payable in any event while shareholders make an investment and share in profits and risks of loss associated with the operation of the business. *See In re* Larson, 862 F.2d 112, 117 (7th Cir. 1988); *see also* Bauer v. Comm'r, 748 F.2d 1365, 1367 (9th Cir. 1984); A.R. Lantz Co. v. United States, 424 F.2d 1330, 1334 (9th Cir. 1970). The outward form of the transaction is not controlling. Rather, the most important factor is the actual intent of the parties as evidenced by the conditions and circumstances of the transaction. *See Bauer,* 748 F.2d at 1367-68; *see also Lantz,* 424 F.2d at 1333-34. This intent is determined by focusing on the following: (1) the identity of the parties; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the presence or absence of rights of enforcement in the event of delinquency; (5) participation in management; (6) subordination to or preference over existing creditors; (7) the adequacy of capitalization; (8) the identity of interest between creditors and shareholders; (9) the payment of interest from dividend money; and (10) the ability of the corporation to obtain loans from outside lending institutions. *See Bauer,* 748 F.2d at 1368; *see also Lantz,* 424 F.2d at 1333; *In re* Pac. Express, Inc., 55 B.R. 913, 919 (Bankr. E.D. Cal. 1985). However, no single factor is controlling or decisive in making the distinction

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transaction is a loan rather than a capital contribution rests with the taxpayer.[51]

*Question Numbers 3 and 4*

Commercial landlords pass through a myriad of expenses to their tenants. As noted in the above-referenced facts, commercial landlords may pass through a proportionate share of maintenance, repair, operating and capital improvement costs, real and personal property taxes, insurance premiums, utility charges, overhead and legal, accounting, inspection and consultation fees associated with the leased property. As in the case of DBC's lease with SVP, these expenses may be included in the tenant's rental obligation as defined in the lease. In addition to leasing the premises upon which the business is to be conducted, DBC also leased most of the equipment to be utilized in the actual conduct of its business, including the washer/extractor/dryers, washers, dryers, pressing machines and computer system.

Tax treatment of expenses incurred under such circumstances is dependent upon the nature of the underlying agreements. If the underlying agreements are characterized as leases, the lessee is permitted to deduct the rental payments as ordinary and necessary business expenses.[52] However, if the purported lease can be more properly characterized as an installment purchase, the lessee will not be permitted to deduct the full amount of the rental payment. Rather, the lessee will be entitled to deduct the portion of the payment representing ordinary and necessary expenses related to the property as well as the portion of the rental payment representing interest.[53] In addition, the lessee will be entitled to deduct the appropriate amount of depreciation on the asset as if the lessee owned the asset.[54]

The issue of whether a lease agreement is in substance a sales contract is dependent upon the intent of the parties as demonstrated by the provisions of the agreement.[55] There is no general rule applicable to all lease agreements.[56] Rather, each case must be decided in the light of its particular facts.[57] It is important to note that even if the agree-

between debt and equity. *See Bauer,* 748 F.2d at 1368; *see also* Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969); *Pac. Express,* 55 B.R. at 919.

[51] *See Bauer,* 748 F.2d at 1368; *see also* O.H. Kruse Grain & Milling v. Comm'r, 279 F.2d 123, 125 (9th Cir. 1960).

[52] *See* I.R.C. § 162(a)(3) (2000).

[53] *See* Rev. Rul. 72-408, 1972-2 C.B. 86, 87.

[54] *See id.* at 87.

[55] *See* Guaderrama v. Comm'r, 79 T.C.M. (CCH) 1752, 1756 (2000); *see also* Lieber v. Comm'r, 66 T.C.M. (CCH) 529, 536 (1993); Northwest Acceptance Corp. v. Comm'r, 58 T.C. 836, 845 (1972); Martin v. Comm'r, 44 T.C. 731, 741 (1965); Berry v. Comm'r, 43 T.C. 723, 730 (1965).

[56] *See Lieber,* 66 T.C.M. at 536.

[57] *See id.* at 536; *see also Guaderrama,* 79 T.C.M. at 1756; *Northwest Acceptance Corp.,*

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ment makes no provision for the transfer of title or specifically precludes the transfer of title, the contract may still be deemed a purchase for tax purposes.[58] A lease agreement may be treated as a purchase for tax purposes if portions of the lessee's rental payments are applied directly to an equity interest to be acquired by the lessee[59] or if the agreement provides that the lessee will eventually acquire title.[60] A lease agreement may also be deemed to be a purchase if the total amount that the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title[61] or if the agreed "rental" payment materially exceeds the current fair rental value.[62] In addition, an agreement may be held to be a purchase rather than a lease if it contains a purchase option at a price that is nominal relative to the value of the property.[63] Finally, if some portion of a periodic payment made pursuant to the purported lease is specifically designated as interest or is equivalent to interest, the transaction may be properly characterized as a purchase agreement.[64]

*Question Number 5*

Employees and independent contractors are agents of the principal on whose behalf they are rendering labor or services. Employees are generally defined as persons whose labor or services are utilized by third parties and who are subject to their control or right to control. This right to control the employee's performance is the primary benefit of the employer-employee relationship. However, the employer is liable for injuries caused to third parties as a result of the actions of the employee performed within the scope of employment. By contrast, independent contractors are defined as persons whose labor or services are utilized by third persons but who are not subject to control or the

58 T.C. at 845; *Martin,* 44 T.C. at 741.

[58] *See* Rev. Rul. 55-540, 1955-2 C.B. 39, 42.

[59] *See* M & W Gear Co. v. Comm'r, 54 T.C. 385, 394 (1970); *see also Martin,* 44 T.C. at 742; Bowen v. Comm'r, 12 T.C. 446, 464-65 (1949).

[60] *See* Hervey v. R.I. Locomotive Works, 93 U.S. 664, 672-73 (1876); *see also Martin,* 44 T.C. at 740-41; Haggard v. Comm'r, 24 T.C. 1124, 1128 (1955); *Bowen,* 12 T.C. at 461 & 464; Taft v. Comm'r, 27 B.T.A. 808, 812-13 (1933).

[61] *See* New England Tank Indus. v. Comm'r, 50 T.C. 771, 778 (1968); *see also Bowen,* 12 T.C. at 463.

[62] *See Bowen* 12 T.C. at 463. The Tax Court has held that such disparity may be indicative that the payments designated as rent include an element other than payment for the use of the property. *See Lieber,* 66 T.C.M. at 536.

[63] *See* Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54, 56 (8th Cir. 1925); *see also* Lemon v. United States, 115 F. Supp. 573, 578 (W.D. Va. 1953); Holeproof Hosiery Co. v. Comm'r, 11 B.T.A. 547, 556-57 (1928).

[64] *See* Guaderrama v. Comm'r, 79 T.C.M. (CCH) 1752, 1756 (2000); *see also* Mills v. Comm'r, 11 T.C. 25, 34-35 (1948).

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right to control. Rather, independent contractors are free to accomplish the task for which they have been hired as they see fit. The disadvantage of this loss of control is offset by the general rule that principals are not liable for injuries caused by their independent contractors performed within the scope of the agency.

There are also significant differences between employees and independent contractors from a tax standpoint. Employers are required to pay FICA,[65] medical health insurance taxes[66] and employment taxes[67] on compensation paid to employees. Independent contractors receive more favorable tax treatment of unreimbursed business expenses, which they are permitted to deduct in full.[68] However, independent contractors must pay their own share of FICA[69] and medical health insurance taxes.[70] The independent contractor also relinquishes many fringe benefits enjoyed by employees.[71] Self-employed individuals may also incur liability for local and property taxes and license fees depending upon the type of license sought or required and the identity of the issuing entity. Finally, the record-keeping and filing requirements are far more complex for independent contractors.[72]

Businesses are increasingly using independent contractors rather than employees to achieve cost control objectives. However, the determination of employee status is a controversial area. The Internal Revenue Service has created a twenty-factor test for determining whether a worker is an employee or an independent contractor.[73]

[65] *See* I.R.C. § 3111(a) (2000).

[66] *See id.* § 3111(b).

[67] *See id.* § 3102(a).

[68] *See id.* § 1402(a). In order to be able to deduct unreimbursed business expenses, an employee must itemize deductions and reduce the amount of the itemized business expense deduction by two percent of his or her adjusted gross income. *See* Treas. Reg. § 1.62-1T(e)(3) (as amended in 1992).

[69] *See* I.R.C. § 1401(a) (2000).

[70] *See id.* § 1401(b).

[71] Examples of fringe benefits that are relinquished by independent contractors include employer-provided health insurance, meals and lodging, cafeteria plans and employee discounts. *See id.* §§ 106(a), 119(a)(1) & (2), 125(d)(1)(A) & 132(c)(1).

[72] *See generally* I.R.S., PUB. 533, SELF-EMPLOYMENT TAX (2000).

[73] *See* Rev. Rul. 87-41, 1987-1 C.B. 296, 298. Factors relevant to the creation of an employer-employee relationship may be summarized as follows: (1) the requirement to comply with the employer's instructions with respect to the performance of the work; (2) the existence and need for training; (3) the integration of the worker's services into the business; (4) the requirement of personal rendition of services; (5) the identity of the person responsible for hiring, supervising and paying subagents; (6) the length of the relationship; (7) the setting of hours of work by the employer; (8) the absence of freedom to work for others; (9) the location where the work is performed; (10) the employer's control of the sequencing of the work; (11) the requirement to submit regular reports; (12) the payment of a salary or lump sum at the end of the job; (13) the reimbursement of business expenses by the employer; (14) the furnishing of tools by the employer; (15) the furnishing of facilities by the employer; (16) the retention of the right to discharge by the

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According to the Internal Revenue Service, employees are subject to the employer's control or right to control concerning performance of their duties, including hours, sequence of work, tools and facilities.[74] Further hallmarks of the employer-employee relationship include the existence of employer-provided training, the requirement of personal and full time performance by the employee and requirements relating to reporting of activities.[75] Finally, employees are usually compensated by the hour, week or month with business expenses incurred in performance of the employment paid by the employer.[76] By contrast, workers who are able to realize profit or loss from their services, work for a number of organizations simultaneously and make their services available to the general public will be deemed to be self-employed.[77] However, the presence or absence of no one factor is controlling, and the list of factors is not deemed exclusive.[78] Nevertheless, these factors take precedence over the label, designation or description that the parties have attached to their relationship.[79] In any event, it is important to note that close cases will be resolved in favor of the existence of an employment relationship.[80]

There are substantial risks to Martin and Philip, as well as those persons they hire as independent contractors, if the IRS determines that these persons should be classified as employees. For example, in 1998, the Internal Revenue Service estimated that more than one-half of the five million independent contractor relationships it reviewed should be reclassified as employer-employee relationships.[81] Between 1988 and 1998, the Internal Revenue Service assessed more than $670 million in penalties and back taxes and reclassified more than 430,000 independent contractors as employees.[82] Reclassification of independent

employer; and (17) the right of the worker to terminate the relationship. *See id.* at 298-99; *see also* I.R.S., PUB. 15-A, EMPLOYER'S SUPPLEMENTAL TAX GUIDE 5-8 (2002) (focusing on behaviorial control, financial control and the type of relationship in order to distinguish between employees and independent contractors with examples).

[74] *See* Rev. Rul. 87-41, 1987-1 C.B. 296, 298; *see also* Treas. Reg. § 31.3121(d)-1(c)(2) (as amended in 1980); Treas. Reg. § 31.3306(i)-1(b) (1960); Treas. Reg. § 31.3401(c)-1(b) (as amended in 1970).

[75] *See* Rev. Rul. 87-41, 1987-1 C.B. 296, 298-99.

[76] *See id.* at 299.

[77] *See id.*

[78] *See* Breaux & Daigle, Inc. v. United States, 900 F.2d 49, 52 (5th Cir. 1990).

[79] *See* Treas. Reg. § 31.3121(d)-1(a)(3) (as amended in 1980); *see also* Treas. Reg. § 31.3306(i)-1(d) (1960); Treas. Reg. § 31.3401(c)-1(e) (as amended in 1970).

[80] *See Breaux,* 900 F.2d at 52; *see also* Tex. Carbonate Co. v. Phinney, 307 F.2d 289, 292 (5th Cir. 1962); Westover v. Stockholders Publ'g Co., 237 F.2d 948, 951 (9th Cir. 1956); Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Higgins, 189 F.2d 865, 869 (2d Cir. 1951); *In re* McAtee, 126 B.R. 568, 572 (Bankr. N.D. Iowa 1991).

[81] *See* Aureon A. Herron, et al., *How to Survive an Employment Tax Audit,* TAX ADVISER MAY 1998, at 328.

[82] *See id.*

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contractors to employee status is costly because the offending firm and other parties responsible for withholding may be assessed the employer's share of payroll taxes as well as interest and penalties.[83] If the employer is insolvent, the owners, officers and directors may be held responsible for such payments.[84] Workers may also be assessed substantial additional taxes as many of the previously noted deductions, such as business-related expenses, travel expenses, home office deductions and contributions to pension plans, are lost upon reclassification.

## TAXATION ISSUES IN THE OPERATION OF A BUSINESS

### *Factual Background*

DBC opened for business in the Danville Commons Shopping Center two weeks after the completion of the landlord's modifications to the premises. Unfortunately, DBC immediately encountered problems in its operations. Philip and Martin's estimates of business to be generated by DBC proved inaccurate, and DBC was resultantly cash-poor. This lack of income contributed to DBC's repeated inability to timely remit rental payments to SVP. DBC also encountered difficulty meeting other financial obligations, such as remittance of equipment lease payments to CPE and payments due to miscellaneous suppliers. The growing success of VGD's operations kept Martin from devoting as much attention to DBC as he had promised Philip, thereby depriving the business of needed experience, leadership and guidance. As the business began to lose ever-greater amounts of money, Martin began to consciously distance himself from its operations, fearing the impact of the business' impending failure upon his other operations. In any event, despite his best efforts, Philip lacked the necessary business training and experience and knowledge of the dry cleaning industry to transform DBC into a successful operation. Philip began to lose interest in the business as longer and longer hours at the store failed to reverse the business' decline. The business began to suffer from this lack of

[83] *See* I.R.C. §§ 3403 & 6672(a) (2000); *see also* Smith v. United States, 894 F.2d 1549, 1553-54 (11th Cir. 1990); Treas. Reg. § 301.6601-1(a) (as amended in 1997). Penalties for failing to withhold taxes range from 1.5% to 3% of the wages paid to the affected employees. *See* I.R.C. §§ 3509(a)(1) & (b)(1)(A) (2000). Penalties for failing to properly account for FICA taxes range from 20% to 40% of the amount of the tax at issue. *See id.* §§ 3509(a)(2) & (b)(1)(B). Furthermore, any person required to collect, account for and pay over such taxes who willfully fails to do so or who attempts to evade or defeat such taxes is personally liable in an amount of 100% of the amount that should have been remitted. *See id.* § 6672(a).

[84] *See* Randall W. Roth & Andrew R. Biebl, *A Taxing Matter: When is a Worker an Independent Contractor?*, J. ACCT., May 1991, at 34, 36.

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attention. Three incidents occurring within two years of DBC's opening for business are demonstrative of its misfortunes.

Shortly after DBC's opening, Martin referred the principal of Altamont High School for purposes of entering into a contract to dry clean the uniforms of the school's one hundred member marching band before its scheduled appearance in the Tournament of Roses Parade in Pasadena, California. The job was by far the largest contract ever offered to DBC, which it managed to obtain despite its small size and lack of experience in the industry. Unfortunately, the solvent applied to the band uniforms was contaminated, thereby resulting in damage to fifty of the uniforms submitted for cleaning. As a result, the band was required to procure replacement uniforms for the parade on short notice at a cost of $15,000. The Altamont School District (ASD) ultimately brought a civil action against DBC for the cost of obtaining the replacement uniforms. Although DBC was successful in convincing the court that its supplier, Dry Cleaning Chemicals, Inc. (DCCI), was partially responsible for ASD's damages, the court held DBC liable for all the injuries suffered by the school upon its claim of breach of contract. The court held that, despite the contaminated solvent, DBC failed to adequately maintain the filter and monitor the solvent in its washer/extractor/dryers, thus contributing to the damage to the band uniforms. The court further awarded $7500 to DBC on its third-party complaint against DCCI.

DBC subsequently paid the full amount of the judgment with interest to ASD and recovered $5000 from DCCI, but the resultant damage to DBC's reputation was irreparable. Furthermore, in response to Philip's instructions to dispose of any remaining solvent supplied by DCCI, one of DBC's employees was caught covertly dumping such solvent in a local sewer. DBC was subsequently cited for illegally disposing of hazardous chemicals by the Contra Costa County Water District (CCCWD) and was fined $7500.

Of a more serious nature was litigation commenced in the Superior Court of Contra Costa County relating to an automobile accident in which the DBC delivery van operated by Will Harms ran a stop sign and struck and severely injured Curtis Walker as he crossed a street in Danville. At the time of the accident, Harms was en route to an after-work meeting with a friend. At trial, the jury found that, although Harms was on a personal errand at the time of the accident, DBC was aware of Harms' past and current use of its delivery van for personal errands. As such, the jury concluded that DBC was responsible for Walker's injuries. The jury awarded $100,000 to Walker as compensatory damages for physical injuries incurred in the accident. Furthermore, the jury awarded Walker $50,000 as compensatory damages for emotional and mental distress incurred as a result of the accident.

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Finally, evidence was adduced at trial that Harms had accumulated numerous moving violations during his driving career, including a citation for speeding and a citation for unsafe lane change while employed as a driver for DBC. Further evidence presented at trial indicated that neither Philip, Martin or any other employee of DBC adequately investigated Harms' driving record prior to his employment by DBC, prohibited Harms from continuing to use the delivery van for personal errands or took any disciplinary action after either of the traffic offenses or the accident. The jury concluded that such behavior was reckless and grossly negligent, thereby justifying an additional award of $50,000 in punitive damages against DBC.

*Teaching Objectives*

This portion of the case study is designed with one teaching objective in mind, specifically, the tax treatment of awards of damages. Although damages, their definition and calculation are discussed in all the surveyed textbooks, the discussion ends with their definition[85] and collection.[86] As a result, students may be left with the misimpression that damage awards do not have accompanying tax consequences and serve as a windfall to the recipient. Thus, this portion of the case study highlights five related issues concerning damages designed to further student understanding of the consequences flowing from such awards.

The initial fact pattern set forth within this portion of the case study focuses upon the taxation issues arising from a breach of contract action. Specifically, this portion of the case study examines the deductibility and taxability of compensatory damage awards for pecuniary loss. The second fact pattern set forth within this portion of the case study focuses upon taxation issues arising from a tort action. This portion of the case study examines the deductibility of compensatory damages for physical and mental injury as well as the deductibility of punitive damage awards. Related to both of these fact patterns is the

[85] *See* BARNES, *supra* note 5, at 250-51, 318-20 & 327-28; *see also* BIXBY, *supra* note 5, at 78-79 & 402-4; BOHLMAN & DUNDAS, *supra* note 5, at 269-70; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 267-69 & 277; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 293-96; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 298-300; CLARKSON, *supra* note 5, at 308-12; JENNINGS, *supra* note 5, at 391; Kubasek, *supra* note 5, at 220-23; MALLOR, *supra* note 5, at 342-45; MCADAMS & PINCUS, *supra* note 6, at 168-69; MILLER & CROSS, *supra* note 5, at 299-300; WARNER, *supra* note 6, at 221-23; WHITMAN & GERGACZ, *supra* note 6, at 243-44.

[86] *See* BARNES, *supra* note 5, at 737-52; *see also* BIXBY, *supra* note 5, at 538-39; BOHLMAN & DUNDAS, *supra* note 5, at 398-401; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 278 & 461; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 487-88; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 407-8; CLARKSON, *supra* note 5, at 64-65 & 531-36; KUBASEK, *supra* note 5, at 586-88; MALLOR, *supra* note 5, at 31-32; MCADAMS & PINCUS, *supra* note 6, at 491-93; MILLER & CROSS, *supra* note 5, at 329-35.

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issue of the deductibility of administrative fines, penalties and similar payments for violations of law. The instructor may choose to present a general survey of the tax consequences flowing from the award of damages as set forth in the case study or may elect to focus on the tax treatment of a specific type of damage award. Other related topics worthy of class discussion are the policies underlying these tax treatment rules and their underlying fairness.

*Questions for Discussion*

1. Should judgment creditors be required to report favorable awards of compensatory damages for pecuniary loss as income? Under what circumstances should such awards be taxable as income? In this regard, should DBC be required to report the award of compensatory damages entered in its favor against DCCI as income? Why or why not?
2. Should judgment debtors be permitted to deduct awards of compensatory damages entered against them? Under what circumstances should such awards be tax deductible? In this regard, should DBC be permitted to deduct the award of compensatory damages entered against it in favor of ASD? Why or why not? Should DBC be permitted to deduct the award of compensatory damages entered against it in favor of Walker? Why or why not?
3. Should judgment debtors be permitted to deduct awards of punitive damages entered against them? Under what circumstances should such awards be deductible? In this regard, should DBC be permitted to deduct the award of punitive damages entered against it in favor of Walker? Why or why not?
4. Should businesses found guilty of wrongdoing be permitted to deduct administrative fines, penalties and similar payments arising from such wrongdoing? Under what circumstances should such fines, penalties and payments be deductible? In this regard, should DBC be permitted to deduct the fine assessed against it by the CCCWD? Why or why not?

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*Answers to the Discussion Questions*

*Question Number 1*

As a general rule, a taxpayer's gross income includes all income from whatever source derived unless the law provides an exception.[87] With respect to awards of damages, the Internal Revenue Code determinesthe purpose of such awards in order to determine their taxability. Specifically, Section 104 of the Code provides that, except for punitive damages, gross income does not include the amount of any damages received on account of personal physical injuries or physical sickness.[88] By contrast, the U.S. Supreme Court has held that, as punitive damages are not intended to compensate injured parties, they are not excludable from gross income.[89] In this case, as the award of damages received by DBC on its third party complaint against DCCI was based strictly upon commercial loss rather than physical injury or sickness, such damages are clearly includable within DBC's gross income and are subject to taxation.

*Question Number 2*

As a general rule, a tax deduction is permitted for all ordinary and necessary expenses paid or incurred in carrying on a trade or business.[90] The Internal Revenue Code does not define the terms "ordinary and necessary." However, the courts have defined these terms on several occasions. The U.S. Supreme Court has held that an expense is necessary if a prudent businessperson would incur the expense, and the expense is expected to be appropriate and helpful to the business.[91] An expense is ordinary if it is normal, usual or customary in the type of business conducted by the taxpayer and, most importantly, is not capital in nature.[92]

To determine whether damages awarded and paid are deductible, the origin and character of the claim must be considered.[93] Payments of civil

[87] *See* I.R.C. § 61(a)(1-15) (2000).

[88] *See id.* § 104(a)(2).

[89] *See* O'Gilvie v. United States, 519 U.S. 79, 83-84 (1996).

[90] *See* I.R.C. § 162(a)(1-3) (2000).

[91] *See* Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 353 (1971); *see also* Comm'r v. Tellier, 383 U.S. 687, 689 (1966); Welch v. Helvering, 290 U.S. 111,113 (1933); *In re* Matter of Federated Dep't Stores, Inc., 171 B.R. 603, 607-8 (Bankr. S.D. Ohio 1994).

[92] *See* Indopco, Inc. v. Comm'r, 503 U.S. 79, 85-86 (1992); *see also* Deputy v. Du Pont, 308 U.S. 488, 495-96 (1940). A capital expenditure is one that benefits the taxpayer in future tax years. Typically, capital expenditures are not deducted in their entirety in the year of the expenditure but rather over a number of years.

[93] *See* United States v. Gilmore, 372 U.S. 39, 49 (1963); *see also* Dana Corp. v. United States, 174 F.3d 1344, 1351 (Fed. Cir. 1999); Northwestern Ind. Tel. Co. v. Comm'r, 127 F.3d 643, 646 (7th Cir. 1997); *In re* Kroy (Eur.) Ltd., 27 F.3d 367, 369-70 (9th Cir. 1994).

damages, whether by judgment[94] or settlement agreement[95] arising out of ordinary business operations are generally deductible as business expenses. Payments of damages arising out of capital transactions may have to be spread over several years[96] or may be disallowed in their entirety.[97] Payments of civil damages arising out of non-business transactions or relationships generally are not deductible.

Applying these standards to the damage awards in the litigation between ASD and DBC, it may be concluded that the award arising from the damaged band uniforms is an expense that a prudent business person may incur, is helpful to the business to the extent that its payment satisfies an outstanding legal obligation and clearly arose from the ordinary operation of the company in the dry cleaning business. As such, the damages award in favor of ASD may be deducted by DBC from income upon payment.

However, the deductibility of the award of damages against DBC in favor of Walker for personal injuries arising as a result of the accident involving Harms is more problematic. Although such damages may be an expense that a business person operating a company that offers a delivery service may incur, the award arose out of conduct that was not related to DBC's ordinary operations as Harms was on a personal errand at the time of the accident. Furthermore, the jury found that this accident may have been avoided had DBC engaged in action that an ordinary business would have undertaken under similar circumstances, such as inquiry into Harms' driving record prior to employment, adoption of a prohibition upon personal use of company vehicles and leveling of appropriate discipline upon the occurrence of violations of traffic laws or company rules. Furthermore, the jury concluded that DBC's conduct concerning Harms' employment was grossly negligent and reckless, thereby justifying an award of punitive damages. As such, it may be contended that the damages awarded and paid to Walker arise from extraordinary circumstances outside the ambit of DBC's ordinary operations.

Nevertheless, a deduction has been permitted for damages arising out of the negligent operation of a company car on personal business by

[94] *See* Graham v. Comm'r, 40 T.C. 14, 22 (1963); *see also* Caldwell & Co. v. Comm'r, 24 T.C. 597, 611 (1955); Levitt & Sons, Inc. v. Comm'r, 5 T.C. 913, 929 (1945); Hales-Mullaly, Inc. v. Comm'r, 46 B.T.A. 25, 34-35 (1942), *aff'd*, 131 F.2d 509, 511-12 (10th Cir. 1942).

[95] *See* Am. Envelope Co. v. Comm'r, 29 T.C. 307, 312 (1957); *see also* Marks v. Comm'r, 27 T.C. 465, 467 (1956); Camloc Fasteners Co. v. Comm'r, 10 T.C. 1024, 1029 (1948); *Levitt & Sons, Inc.*, 5 T.C. at 929; Int'l Shoe Co. v. Comm'r, 38 B.T.A. 81, 96-97 (1938).

[96] *See* Mount Morris Drive-In Theatre Co. v. Comm'r, 238 F.2d 85, 86 (6th Cir. 1956); *see also* Radio Station WBIR, Inc. v. Comm'r, 31 T.C. 803, 812 (1959); *Am. Envelope Co.*, 29 T.C. at 312.

[97] *See* Brush-Moore Newspapers, Inc. v. Comm'r, 95 F.2d 900, 902 (6th Cir. 1938).

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a person who was neither a stockholder nor an employee.[98] Having been named as a defendant in the ensuing litigation and advised by counsel that it may be found liable for negligent entrustment, the company paid part of the settlement and legal fees.[99] As the corporation was directly involved in the litigation, its exposure to the risk of a judgment was substantial and its assets were placed in jeopardy, the expenses incurred by the corporation were deductible.[100] Thus, DBC may deduct the damages awarded and paid to Walker despite the fact that they arose from the use of the company van for Harms' personal purposes.

*Question Numbers 3 and 4*

The deductibility of the award of punitive damages entered against DBC and the fine assessed against DBC by the CCCWD depends upon whether the purposes of such award and fine are punitive or compensatory. Generally speaking, fines, penalties, treble damages and similar payments for violations of law, as well as settlements made in lieu of such penalties, are nondeductible.[101] However, if the fine or penalty is determined to be compensatory in nature, rather than one imposed as punishment or deterrence, the payment may be deductible as a business expense. For example, in 1996, the U.S. Tax Court held that penalties paid to the North Carolina and Virginia Departments of Agriculture by a producer and supplier of fertilizer were deductible because the penalties were designed to compensate consumers who bought deficient fertilizer.[102] However, an $8 million payment to a clean-up fund for toxic pollution caused by the taxpayer was determined to be punitive in nature in the case of *Allied Signal, Inc. v. Commissioner.*[103] As the payment did not directly compensate aggrieved parties for specific losses caused by the taxpayer, the Tax Court held that the payment served a more general public purpose and thus was not deductible.[104] Applying these standards to the award of punitive damages arising out of the Harms' traffic accident, it may be concluded that such damages are not deductible by DBC as they were intended to serve a deterrent purpose rather than a compensatory purpose. The administrative fine payable to the CCCWD could be convincingly in either fashion. Generally speaking, administrative fines are designed to serve a public

[98] *See* Kopp's Co. v. United States, 636 F.2d 59, 61 (4th Cir. 1980); *see also* Anderson v. Comm'r, 81 F.2d 457, 460 (10th Cir. 1936); Mulgrew Blacktop, Inc. v. United States, 311 F. Supp. 570, 572 (S.D. Iowa 1969).

[99] *See Kopp's Co.,* 636 F.2d at 61.

[100] *See id.*

[101] *See* I.R.C. § 162(f) (1994).

[102] *See* Jenkins v. Comm'r, 72 T.C.M. (CCH) 1470, 1473 (1996).

[103] 63 T.C.M. (CCH) 2672, 2682 (1992).

[104] *See id.* at 2682.

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purpose by punishing wrongdoers. In such case, the fine would not be deductible. However, if the fine was utilized to provide compensation to affected water customers or to remediate contamination, DBC may be able to advance a strong argument in favor of deductibility.

## TAXATION ISSUES IN BUSINESS DISSOLUTION

### *Factual Background*

The previously referenced events and DBC's continuing lack of financial success led to a souring of the relationship between Martin and Philip. Martin accused Philip of mismanagement, lack of proper supervision of DBC employees, excessive and unauthorized diversion of business revenues for Philip's personal use and failure to spend adequate time managing the business. Martin also accused Philip of failing to pay DBC's bills as they became due, including annual remittances to the California Secretary of State's office resulting in the suspension of DBC's corporate charter. As a result of these failures, Martin claimed that he had suffered a loss of reputation in the East Bay business community. Martin alleged that this damage to his reputation would undoubtedly have a negative effect upon his future success as well as that of VGD. For his part, Philip accused Martin of failing to adequately capitalize the business from its inception and devote adequate time and attention in advising Philip concerning the specifics of successful business management. As a result, by the beginning of DBC's fifth year of corporate existence, it was clear that Martin and Philip were no longer interested in owning and operating a business together. Unable to find a purchaser of the business as a whole or their respective shares, they began to actively consider termination of DBC's operations.

Martin and Philip contemplated a number of options with respect to the discontinuance of DBC's operations. Initially, they considered whether to voluntarily dissolve DBC through the filing of articles of dissolution, winding up of the business' operations and liquidation of its assets. Unable to reach agreement with respect to DBC's financial affairs, including Philip's inability to render a final accounting, Martin threatened to seek an involuntary dissolution of the business on the basis of Philip's alleged misappropriation of revenues, abuse of corporate powers and abandonment of the company's business by permitting its corporate charter to be suspended. In response to Martin's threat to involuntarily dissolve the business and accuse him of numerous improprieties, Philip threatened to liquidate DBC in bankruptcy court. According to Philip, this course of action would ensure an orderly payoff of creditors as well as discharge of corporate debts unable to be satisfied by existing assets. Philip was also aware of

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Martin's aversion to any bankruptcy proceeding as a further blot upon his business reputation.

As a result of these threats, Martin and Philip agreed to voluntarily dissolve DBC, wind up its operations and liquidate its assets. However, upon inspecting the company's books for purposes of marshaling its assets, Martin noticed several questionable entries made by Philip. These entries reported less gross income earned from the business than Philip had led Martin to believe in previous reports of corporate income. Based upon these entries, Martin concluded that Philip had provided false income statements to him in order to conceal his skimming of corporate earnings. The apparent maintenance of two separate sets of corporate books led Martin to express concern regarding the accuracy of income reported to relevant tax authorities on DBC's corporate returns as well as the parties' personal returns. Philip responded to these accusations by acknowledging the disorderly manner in which the corporate records and accounts were maintained but denying any intent to defraud Martin or relevant tax authorities. If he was responsible for anything, Philip stated that he was guilty of naïveté in entering into a business relationship with his vastly more sophisticated brother. In any event, any understatements of income reported on DBC's income tax returns or the personal returns of Martin and Philip were the result of "accidental underreporting rather than intentional income tax evasion." Nevertheless, despite his initial reluctance, Martin moved to place DBC under the control of a trustee in involuntary bankruptcy proceedings as a result of the income reporting anomalies as well as other financial irregularities.

*Teaching Objectives*

There are three teaching objectives with respect to this portion of the case study. Initially, students may supplement their knowledge regarding voluntary and involuntary dissolution of businesses by exploring the tax ramifications of such occurrences. These discussions may focus on the dissolution of the corporate form of business as referenced in the case study or may choose to contrast the tax ramifications of the dissolution of other types of business entities, such as general and limited partnerships and limited liability companies. Issues that may be explored include the extent of liability of the entity and individuals comprising the entity for taxes and the priority of taxes over other business debts and obligations.[105]

[105] *See* BARNES, *supra* note 5, at 409, 425-33 & 455; *see also* BIXBY, *supra* note 5, at 248-49 & 278-79; BOHLMAN & DUNDAS, *supra* note 5, at 506-8 & 541; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 564, 595-96 & 652-55; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 587-590, 594 & 678-80; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 324-26; JENNINGS, *supra* note 5, at 854; KUBASEK, *supra*

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The second objective of this portion of the case study is to supplement student understanding of bankruptcy through an exploration of the tax consequences of such filings. Liquidation proceedings were selected for the case study given the unlikely occurrence of a reorganization of a business as small as DBC's dry cleaning operation. Similar to the objective concerning business dissolution, class discussions may focus on corporate and individual liability for unpaid taxes as well as their priority upon dissolution and distribution of the bankruptcy estate.[106]

Finally, this portion of the case study focuses on the issues of underreporting of income and tax evasion. Three important concepts are conveyed to students concerning these issues. It is important to initially define and distinguish between the concepts of underreporting and evasion. Second, students may explore the penalties associated with underreporting and evasion. Finally, the issues of corporate and individual liability for underreporting and evasion should be discussed to emphasize the seriousness of such practices.[107]

*Questions for Discussion*

1. What is a voluntary dissolution of a business? Under what circumstances may a voluntary dissolution of a business occur? What is an involuntary dissolution of a business? Under what circumstances may an involuntary dissolution occur? What are the tax ramifications of a dissolution of a business?
2. How are delinquent income taxes collected by the Internal Revenue Service?
3. What crimes may arise from Philip's activities with respect to DBC's business? What are the elements of these crimes? What are the possible penalties associated with each of these crimes?
4. What is a liquidation bankruptcy? What is the priority of unpaid taxes if there is such a bankruptcy? Should the

note 5, at 338-39; MALLOR, *supra* note 5, at 782-97, 811-14 & 895; MCADAMS & PINCUS, *supra* note 6, at 104-8; MILLER & CROSS, *supra* note 5, at 396-97; WARNER, *supra* note 6, at 280, 284-85, 289 & 303.

[106] *See* BARNES, *supra* note 5, at 779-801; *see also* BIXBY, *supra* note 5, at 544-51; BOHLMAN & DUNDAS, *supra* note 5, at 401-8; CHEESEMAN, BUSINESS LAW, *supra* note 5, at 482-501; CHEESEMAN, CONTEMPORARY BUSINESS LAW, *supra* note 5, at 497-516; CHEESEMAN, THE LEGAL AND REGULATORY ENVIRONMENT, *supra* note 6, at 408-18; KUBASEK, *supra* note 5, at 609-10; MALLOR, *supra* note 5, at 583-607; MCADAMS & PINCUS, *supra* note 6, at 504-9; MILLER & CROSS, *supra* note 5, at 339-60; WARNER, *supra* note 6, at 502-5.

[107] One of the surveyed legal environment and business law textbooks specifically addressed underreporting of income and tax evasion and the consequences arising therefrom. *See* JENNINGS, *supra* note 5, at 325 ( evasion and associated penalties).

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individuals comprising the business be personally liable for outstanding taxes if there is such a bankruptcy? Why or why not?

*Answers to the Discussion Questions*

*Question Number 1*

Dissolution of a business may occur on a voluntary or involuntary basis. Voluntary dissolution of a general partnership occurs as a result of an agreement by the general partners to discontinue the business or any change in the number or identity of the general partners. The limited partnership form of business is more flexible concerning dissolution. Although the general partners may agree to discontinue the business, the limited partnership does not dissolve if there is a change in the number or identity of the limited partners or the general partners, unless there are no remaining general partners as a result of the occurrence in question. Voluntary dissolution of a corporation occurs upon the decision of the board of directors or, in some instances, the shareholders, to discontinue the business. In such circumstances, the corporation is officially dissolved through the filing of articles of dissolution with the appropriate secretary of state's office. Dissolution of a business may also occur on an involuntary basis. Involuntary dissolution occurs through the issuance of a court order upon the filing of litigation seeking termination of the entity's existence by the state attorney general, other related law enforcement authorities or financially interested parties such as partners or shareholders. The bases upon which such dissolution may occur include fraud, disregard of legal requirements concerning the operation of the entity, abandonment of the entity's business or failure to remit required payments and fees to the state. The financial affairs of the entity are generally placed under the control of a receiver, an independent third party whose duty it is to wind up the business for ultimate liquidation.

However, the dissolution of a business does not terminate its existence for tax purposes. As the Van Gend brothers selected a corporation as the means of operating their dry cleaning business, the tax rules with respect to corporate dissolution are relevant. Specifically, the dissolution of a corporation does not relieve it of the responsibility of filing a return covering the portion of the applicable tax year prior to the dissolution.[108] Furthermore, the occurrence of an event of dissolution does not immediately terminate the corporation's existence, but rather, requires that it ascertain its assets, identify and satisfy its creditors and prosecute or defend lawsuits to which it is a party. Given these requirements, the corporation remains a taxable entity throughout the

[108] *See* Russell v. United States, 278 U.S. 181, 188 (1929).

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dissolution and liquidation process.[109] This continuing tax status recognizes that the dissolved corporation may incur gains or losses during this period of time for which it is accountable to the Internal Revenue Service.[110] As such, it may be generally concluded that a dissolved corporation undergoing liquidation remains responsible for the filing of returns and payment of applicable taxes as long as its financial affairs remain unsettled.[111] Stated another way, the financial affairs of a corporation will not be deemed settled while there remains the possibility of an additional assessment of taxes against it.[112] This same rule holds true in the event that the corporation's operations are involuntarily turned over to a receiver for liquidation.[113] Furthermore, the Internal Revenue Service retains the right to serve a notice of deficiency upon a corporation even if its corporate existence has been terminated pursuant to applicable state law.[114] However, an involuntarily dissolved corporation whose assets and operations have been turned over to a receiver is not a taxable entity after the expiration of its legal existence.[115]

Furthermore, the dissolution of the business may have individual tax consequences for Martin. Recalling the earlier discussion with respect to tax-free incorporation, if Martin had contributed property to DBC and received an eighty percent ownership interest in return, the unrecognized gain or loss in such property would have been preserved through a carryover of his basis in the transferred property. By contrast, complete liquidation of corporate assets is a recognition event to both the corporation and to its shareholders. Under such circumstances, DBC would recognize gain or loss as if the distributed property had been sold to the shareholders at fair market value.[116] Shareholders must recognize gain or loss on the difference between the fair value of the property received in the distribution and the shareholder's basis in the corporate stock.[117]

[109] *See* Wood Harmon Corp. v. United States, 206 F. Supp. 773, 776 (S.D.N.Y. 1962), *aff'd,* 311 F.2d 918, 923-25 (2d Cir. 1963); *see also* Ungar, Inc. v. Comm'r, 26 T.C. 331, 342-44 (1956), *aff'd,* 244 F.2d 90, 93-94 (2d Cir. 1957).

[110] *See* Treas. Reg. § 1.6012-2(a)(2) (as amended in 1982) (stating that corporations will be treated as taxable entities for as long as they retain assets).

[111] *See id.; See also* Messer v. Comm'r, 52 T.C. 440, 449-50 (1969).

[112] *See* Krueger v. United States, 33 F. Supp. 102, 104 (D.N.J. 1940).

[113] *See Wood Harmon Corp.*, 206 F. Supp. at 776.

[114] *See* Padre Island Thunderbird, Inc. v. Comm'r, 72 T.C. 391, 394-95 (1979); *see also* Brannon's of Shawnee, Inc. v. Comm'r, 71 T.C. 108, 111 (1978); Harold Patz Trust v. Comm'r, 69 T.C. 497, 499 (1977); Great Falls Bonding Agency, Inc. v. Comm'r, 63 T.C. 304, 306-7 (1974).

[115] *See* United States v. McDonald & Eide, Inc., 670 F. Supp. 1226, 1233 (D. Del. 1987).

[116] *See* I.R.C. § 336(a) (2000).

[117] *See id.* §§ 331(a) & 1001(a) & (b).

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Martin may have been able to avoid taxation under such circumstances through a tax-free reorganization. A reorganization is any corporate rearrangement by which the assets of one corporation are transferred to a new corporate entity or retained by the original corporation but controlled by new shareholders. For example, Martin may have been able to avoid taxation if he was able to persuade DBC's creditors to forgive the company's debts in exchange for preferred stock. Reorganizations usually fall into one of four categories. An amalgamating reorganization is where two or more corporations are combined into one entity.[118] By contrast, a divisive reorganization occurs where a single corporation is divided into two or more corporations.[119] A single-party reorganization occurs where a corporation rearranges its internal financial structure without external supervision.[120] Finally, Chapter Eleven reorganization is defined as a reorganization in which a financially distressed corporation seeks bankruptcy court protection and supervision of the restructuring of its affairs for the purpose of reemerging in the marketplace in a more competitive financial condition.[121]

*Question Number 2*

The U.S. income tax system has been aptly characterized as "a self-assessment system that depends upon the voluntary compliance of American taxpayers."[122] However, in order to be effective, this system "cannot depend entirely on the public spirit and generosity of its citizens."[123] Thus, the Internal Revenue Code provides the federal government with extensive civil and criminal remedies against recalcitrant taxpayers. From a civil standpoint, the Code gives the United States a lien for unpaid taxes against real and personal property, and all rights thereto, belonging to a delinquent taxpayer.[124] The purpose of such lien is to protect the Government's position as a creditor in order to facilitate later collection efforts.[125] In order for a tax lien to arise, there must be an assessment of taxes due and owing, service of a demand for payment upon the taxpayer and failure by the taxpayer to pay the tax due.[126] An assessment is a determination by the Internal Revenue Service that a taxpayer is indebted to the federal

[118] *See id.* § 368(a)(1)(A-C).
[119] *See id.* § 368(a)(1)(D).
[120] *See id.* § 368(a)(1)(E & F).
[121] *See id.* § 368(a)(1)(G).
[122] MERTEN, *supra* note 24, § 55A:04 (Supp. 2000).
[123] *Id.*
[124] *See* I.R.C. § 6321 (2000).
[125] *See* Tony Thornton Auction Serv., Inc. v. United States, 791 F.2d 635, 638-39 (8th Cir. 1986).
[126] *See* I.R.C. § 6321 (2000); *see also* 26 C.F.R. § 301.6203-1 (2000).

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government for taxes and occurs upon the entry of the indebtedness in the Service's records.[127] Once in place, the effective date of the tax lien relates back to the date of assessment.[128] Although the lien attaches to all currently owned and subsequently acquired property of the taxpayer, it does not attach to certain exempt property such as personal effects, books and tools of a trade, business or profession, unemployment benefits and child support payments.[129]

A tax lien does not attach to specific property until the Internal Revenue Service files a notice of lien. In order to attach to the taxpayer's real property, the notice of lien must be filed in the appropriate office designated for such filings pursuant to the laws of the state in which the property is located.[130] The filing of a notice of lien with respect to personal property must occur in the location designated by the laws of the taxpayer's domicile.[131] A notice of lien is effective for ten years after filing and must be refiled at the end of such period of time.[132] Nevertheless, there are several categories of creditors that have priority over tax liens. The Internal Revenue Code grants priority to creditors whose interests arose before the filing of the tax lien or who obtained a security interest in the taxpayer's property after the date of the filing pursuant to a written agreement signed before the date of filing.[133] The Code also grants priority to interests maintained by private parties in certain securities, motor vehicles, retail property and mechanic's liens for residential property regardless of when such interest arose.[134] Finally, a creditor's lien may be granted priority where its identity, the properties subject to its lien and the amount of the lien were established prior to the filing of the tax lien.[135]

The Internal Revenue Service has several enforcement tools by which to satisfy the tax lien. The Service may levy upon all non-exempt property in which the taxpayer maintains an interest, including salary and wages, bank accounts and benefits payable from insurance policies, trusts and estates.[136] Real property seized in satisfaction of a tax lien may be subsequently sold by the federal government subject to the taxpayer's right to redemption prior to such sale.[137] The Internal

[127] *See* Treas. Reg. § 301.6203-1 (1967).

[128] *See* I.R.C. § 6322 (2000).

[129] *See id.* §§ 6321 & 6334(a)(1-13).

[130] *See id.* § 6323(f)(1)(A)(i).

[131] *See id.* § 6323(f)(1)(A)(ii).

[132] *See id.* § 6323(g)(3)(A).

[133] *See id.* § 6323(a).

[134] *See id.* § 6323(b)(1-10).

[135] *See* J.D. Court, Inc. v. United States, 712 F.2d 258, 260-61 (7th Cir. 1983).

[136] *See* I.R.C. § 6331(a) (2000).

[137] *See id.* §§ 6337(a) & (b) & 7403(a). There is no right to redemption for personal property.

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Revenue Service may also enforce its lien through litigation, including foreclosure proceedings upon real and personal property in which the taxpayer maintains an interest.[138] Finally, the Internal Revenue Service may elect to resolve the lien through the negotiation, execution and performance of a settlement agreement with the delinquent taxpayer.

*Question Number 3*

The federal government also maintains a panoply of criminal sanctions against non-compliant taxpayers. The criminal provisions of the Internal Revenue Code primarily punish "affirmative acts of concealment intended to avoid a tax obligation and a failure to perform a duty imposed by law."[139] Perhaps the most serious of all tax-related offenses is tax evasion. Tax evasion occurs when any person willfully attempts to evade or defeat a tax or the payment of a tax.[140] The term "any person" includes an officer preparing and signing a fraudulent tax return on behalf of a corporation.[141] The U.S. Supreme Court has held that "any conduct, the likely effect of which would be to mislead or conceal" constitutes an attempt for purposes of tax evasion.[142] Such conduct includes maintaining multiple sets of books, the making of false entries, the concealment of assets and the diversion of corporate income to pay personal expenses.[143] In any event, the conduct must be intentional and voluntary.[144] Such conduct constitutes a separate offense for each tax year in which it occurred.[145] Tax evasion is a felony and is punishable by a $100,000 fine ($500,000 if the taxpayer is a corporation) or imprisonment for no more than five years or both.[146]

There are several less serious offenses associated with misconduct in the preparation and filing of income tax returns and payment of taxes. Section 7202 of the Internal Revenue Code prohibits the willful failure to collect or truthfully account for and pay over federal taxes.[147] Included within this offense is the willful failure of employers to collect

[138] *See id.* §§ 7402(a) & 7403(a).

[139] MERTEN, *supra* note 24, § 55A:04 (Supp. 2000).

[140] *See* I.R.C. §7201 (2000).

[141] *See* United States v. Genser, 582 F.2d 292, 297-98 (3d Cir. 1978); *see also* Currier v. United States, 166 F.2d 346, 348 (1st Cir. 1948).

[142] Spies v. United States, 317 U.S. 492, 499 (1943); *see also* United States v. Klausner, 80 F.3d 55, 62 (2d Cir. 1996); United States v. McGill, 964 F.2d 222, 230 (3d Cir. 1992).

[143] *See Spies,* 317 U.S. at 499; *see also* United States v. Thetford, 676 F.2d 170, 175 (5th Cir. 1982).

[144] *See* Cheek v. United States, 498 U.S. 192, 200 (1991); *see also* United States v. Pomponio, 429 U.S. 10, 12 (1976); United States v. Bishop, 412 U.S. 346, 360 (1973); United States v. Aitken, 755 F.2d 188, 191 (1st Cir. 1985).

[145] *See* MERTEN, *supra* note 24, § 55A:05 (Supp. 2000).

[146] *See* I.R.C. § 7201 (2000).

[147] *See id.* § 7202.

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and remit withholding taxes.[148] Such conduct is a felony and punishable by a $10,000 fine or imprisonment for no more than five years or both.[149] Section 7203 of the Code punishes persons who willfully fail to file income tax returns or pay their taxes when due.[150] Such conduct is punishable as a misdemeanor through the imposition of a fine of not more than $25,000 ($100,000 for corporations) or imprisonment for no more than one year or both.[151] Sections 7204 and 7205 of the Code make it a crime for an employer to file a false or fraudulent W-2 and an employee to file a false or fraudulent W-4, respectively.[152] Section 7206 prohibits the willful making of a false statement with respect to a material matter on any document, including a tax return, submitted under oath to the Internal Revenue Service.[153] Such conduct constitutes a felony punishable by a fine of no more than $100,000 ($500,000 in the case of corporations) or imprisonment for no more than three years or both.[154] Finally, any person who willfully makes a false or fraudulent oral or written statement as to a material fact in a matter within the jurisdiction of a federal agency is guilty of a felony punishable by a fine or imprisonment for no more than five years or both.[155] There is no requirement that the statement at issue be made under oath. As a result, this statute has been held to apply to false statements made by a taxpayer to a revenue agent during the course of an audit or other investigation.[156]

*Question Number 4*

A liquidation bankruptcy is provided for pursuant to Chapter Seven of the U.S. Bankruptcy Code.[157] A liquidation bankruptcy is initiated through the filing of a petition with the appropriate U.S. bankruptcy court. The filing of this petition and provision of appropriate notice to creditors serves to stay all litigation pending against the filer, including all collection efforts of judgment creditors.[158] The filer's property subsequently comes under the control of a trustee whose duties are to

[148] *See* MERTEN, *supra* note 24, § 55A:11 (Supp. 2000).

[149] *See* I.R.C. § 7202 (2000).

[150] *See id.* § 7203. The time to file income taxes returns is set forth in Section 6072 of the Code. Individual returns are due on April 15. *See id.* § 6072. Returns for corporations utilizing a calendar year or fiscal year are due on March 15 and the fifteenth day of the third month after the close of the fiscal year respectively. *See id.*

[151] *See id.* § 7203.

[152] *See id.* §§ 7204 & 7205(a) & (b).

[153] *See* § 7206(1).

[154] *See id.*

[155] *See* 18 U.S.C. § 1001(a)(1-3) (2000).

[156] *See* United States v. Fern, 696 F.2d 1269, 1273 (11th Cir. 1983); *see also* Sica v. United States, 325 F.2d 831, 835 (9th Cir. 1963).

[157] *See* 11 U.S.C. §§ 701-66 (2000).

[158] *See id.* § 362(a)(1-8).

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discover and marshal the bankrupt's assets and distribute them in an orderly fashion to creditors listed in the bankruptcy petition.[159] The bankrupt's creditors are ranked according to their priority for purposes of receiving distributions, with secured creditors generally enjoying priority over judgment creditors and unsecured creditors.[160] Upon completion of this distribution, the bankrupt receives a discharge from further liability for all disclosed indebtedness subject to several exceptions.[161]

Claims against a debtor that could be reduced to a money judgment are dischargeable in a Chapter Seven bankruptcy.[162] However, most tax obligations cannot be discharged in bankruptcy.[163] Initially, federal law exempts taxes incurred during the ordinary course of the debtor's business after a reorganization bankruptcy has been filed and before the appointment of a trustee or before an order granting relief has been granted by the bankruptcy court.[164] Federal law also grants an exemption from discharge for: (1) income taxes for a taxable year that ended on or before the date of the filing of the bankruptcy, if the last due date of the return for such year occurred not more than three years immediately before the date on which the petition was filed, or assessed within 240 days;[165] (2) property taxes assessed before the commencement of the bankruptcy and payable without penalty after one year before the filing of the petition;[166] (3) taxes required to be collected and withheld by the debtor for which the debtor is liable;[167] and (4) employment taxes on monies earned from the debtor before the date of filing of the bankruptcy for which a return was last due three years before the date of the filing of the petition.[168] Additionally, taxes related to a return filed less than two years before the filing of the bankruptcy petition are nondischargeable.[169]

Finally, a taxpayer who has sought to evade taxes, filed a fraudulent return or failed to file a return cannot discharge resultant tax liability.[170] In order to be non-dischargeable on this basis, the taxpayer must engage in a voluntary, conscious or intentional attempt to avoid

[159] *See id.* § 704(1-9).
[160] *See id.* § 726(a)(1-6).
[161] *See id.* § 727(a)(1-10).
[162] *See id.* § 101(5)(A) & (B).
[163] *See id.* § 523(a)(1)(A-C).
[164] *See id.* §§ 502(f) & 507(a)(2).
[165] *See id.* § 507(a)(8)(A)(i-ii).
[166] *See id.* §507(a)(8)(B).
[167] *See id.* § 507(a)(8)(C).
[168] *See id.* § 507(a)(8)(D).
[169] *See id.* § 523(a)(1)(B)(ii).
[170] *See id.* § 523(a)(1)(C); *see also In re* Haas, 48 F.3d 1153, 1158-60 (11th Cir. 1995); *In re* Thompson, 207 B.R. 7, 10 (Bankr. M.D. Fla. 1996).

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or evade a tax.[171] A voluntary and conscious attempt to avoid or evade a tax requires that the law impose upon the taxpayer a duty to pay taxes of which the taxpayer knew and intentionally chose to ignore.[172] The burden of proof rests with the government to demonstrate fraud by a preponderance of the evidence when it chooses to challenge discharge on this basis.[173] This burden is not met by merely demonstrating non-payment of taxes by the bankrupt party without more.[174]

## CONCLUSION

The Dutch Boy Cleaners case study provides exposure to basic principles of tax law as they relate to topics within the curriculum of an introductory business law or legal environment course. Utilizing the common framework of business law and legal environment courses, the case study provides a general survey of tax law in three areas of interest to all businesses, specifically, formation, operation and dissolution. In the area of business formation, the case study provides a general survey of the issues of selection of entity, capitalization, the purchase or leasing of real and personal property and the use of employees and independent contractors. The taxability and deductibility of various types of damages arising from the operation of a business are discussed in the second part of the case study with particular emphasis upon three areas covered in most business law and legal environment courses, specifically, contracts, torts and administrative law. Finally, the portion of the case study devoted to the termination of business operations focuses on dissolution, bankruptcy and liability for underreporting of income and tax evasion.

Given the multiplicity of issues presented, the instructor may close the case study in a variety of ways. The instructor's closing remarks may review the key lessons of the case study. The instructor may emphasize the relevancy of taxation to other topics within the legal curriculum. For example, the case study may serve as a springboard for the discussion of tax law in other areas of the legal studies curriculum, such as the purchase and sale of goods and real property, employment

[171] *See In re* Meyers, 196 F.3d 622, 625 (6th Cir. 1999); *see also In re* Toti, 24 F.3d 806, 808 (6th Cir. 1994); Smith v. United States, 202 B.R. 277, 279-80 (Bankr. S.D. Ind. 1996); Irvine v. Comm'r, 163 B.R. 983, 987 (Bankr. E.D. Pa. 1994); *In re* Berzon, 145 B.R. 247, 250-51 (Bankr. N.D. Ill. 1992); *In re* Jones, 116 B.R. 810, 815 (Bankr. D. Kan. 1990).

[172] *See* Cheek v. United States, 498 U.S. 192, 201 (1991); *see also* United States v. Guidry, 199 F.3d 1151, 1156 (10th Cir. 1999); United States v. Winchell, 129 F.3d 1093, 1097 (10th Cir. 1997); *Toti*, 24 F.3d at 808.

[173] *See* Grogan v. Garner, 498 U.S. 279, 286-90 (1991); *see also In re* Ettell, 188 F.3d 1141, 1145 (9th Cir. 1999); *In re* Crawley, 244 B.R. 121, 125 (Bankr. N.D. Ill. 2000); *Berzon*, 145 B.R. at 250.

[174] *See In re* Fegeley, 118 F.3d 979, 983 (3d Cir. 1997); *see also Haas*, 48 F.3d at 1158-60; *Jones*, 116 B.R. at 814.

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law and international commercial transactions. The instructor may also utilize this opportunity to point out other areas of concern to Martin and Philip, such as contract and tort liability concerns arising from their failed business relationship. The instructor's concluding remarks will of course depend upon the method in which he or she presents the case study to the class. However, regardless of the approach one takes to its presentation, the instructor's closing remarks should recall that the case study is designed as an introduction to tax issues and is not comprehensive. As such, the instructor's emphasis should be upon awareness of taxation issues and basic principles rather than retention and recitation of detailed substantive provisions of the Internal Revenue Code.

Finally, the case study may present two additional benefits for the business law or legal environment instructor. Initially, the case study may serve to enhance the knowledge of legal educators concerning tax law. Tax law is an area that many of us explored only superficially during our own legal education through courses in personal and corporate taxation. Taxation is a field in which many of us did not or currently do not tread in the course of our law practices given its blizzard of arcane rules and procedures and hence its specialized nature. Furthermore, as previously noted, taxation is not an area that receives extensive coverage in the curricula of most business law and legal environment courses. Thus, the case study may present a benefit to legal educators to the extent that it reacquaints them with the Internal Revenue Code and its relevancy to the areas in which they teach.

The other benefit that legal educators may reap from case studies such as the one presented herein is its interdisciplinary nature. In addition to its use in the business law or legal environment course, the case study may be used in a wide variety of accounting courses such as financial and tax accounting and tax planning. The case study may also be of use in certain finance courses such as financial planning and management. Given this overlap, the legal educator may choose to bring in a member of the accounting or finance faculty to present the case study to his or her class as a team. Furthermore, the legal educator may present the case study as part of such a team in the accounting or finance classroom. Such an interdisciplinary approach cannot help but to emphasize to students the integrated nature of their business studies. Furthermore, the benefits of such interdisciplinary collaboration and integration should not be lost upon legal educators who teach a subject matter the relevancy of which in the business school curriculum has been subject to question in the past. Thus, the true value of such case studies may lie in the extent that they attempt to span the actual and perceived chasms between us and our non-legal colleagues.

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