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Federal Income Taxation

Supplemental Reading Materials

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Taxes, Happiness, and Heliocentrism
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The most heavily taxed people in the world say that they are the most satisfied with their lives; the less heavily taxed, not quite so much.

The latest findings on who is happiest come from the Organization for Economic Cooperation and Development, which gathered data from 2006 on 11 measures of life satisfaction. The OECD also measures national tax burdens.

The Danes report by far the most satisfaction with their lives, followed by the Finns, Dutch, Norwegians, and Swiss. The 10 happiest countries are filled out by New Zealand, Australia, Canada, Belgium, and Sweden.

And the United States, which imposes lower tax burdens than any of these 10 countries? The United States ranked 11th, just behind the much more heavily taxed Sweden.

This is not to suggest that paying more taxes equates to happiness. That's absurd. Some countries with higher tax burdens than those of the United States ranked lower in satisfaction, so the relationship between taxes and happiness is more subtle.

Still, these happiness rankings should provoke questions about the relationship between taxes and happiness, or at least its pursuit.

Happiness and Tax Burdens

Country	Taxes as Share of GDP[a]	Satisfaction Rank 2006
Denmark	49.0	1
Finland	43.5	2
Netherlands	39.5	3
Norway	43.6	4
Switzerland	30.1	5
New Zealand	36.5	6
Australia	30.9	7
Canada	33.4	8
Belgium	44.8	9
Sweden	50.1	10
United States	28.2	11

FOOTNOTE TO TABLE

[a] Latest data, either 2006 or 2007. *Source:* OECD.

For those who cling to the dogma that the pursuit of happiness is based on tax cuts, these rankings pose a fundamental challenge. How can higher tax burdens be associated with greater life satisfaction? Higher taxes are supposed to equate with misery, not joy. So how can people who bear a tax burden more than 80 percent greater than that of Americans possibly be happier?

To those who hold that tax cuts are always a good thing, these are questions to be dismissed out of hand. This secular article of faith was on full display earlier this month after President Obama put forth his proposal to start tightening offshore corporate tax loopholes and to crack down on individual tax cheats who hide money in the Cayman Islands and other havens.

The leading defenders of the tax cutting faith appeared at every point on the dial. Generally they are renowned for their witty predictability rather than their knowledge of tax, government finance, or even contentment. Their general approach was to divert attention away from the president's focus on integrity, transparency, and enforcement. Speaking of tax truths as if they came with a capital T, they proclaimed it self-evident that, while necessary, taxes are bad and more taxes are awful.

It does seem that lower taxes are good for us, that each of us would be better off if we could just pay less and keep more of what we make. That lower taxes mean more prosperity seems as obvious as the sun rising in the east and rolling across the sky each day.

But what seems obvious is not always so, especially when facts get in the way of dogma. Imagine human progress if Aristarchus of Samos had won the day nearly 24 centuries ago when he figured out that the earth revolved around the sun, instead of being dismissed as a blasphemer for disputing that earth was the center of the universe.

When Galileo, with his telescope, observed what Aristarchus (and Copernicus) had figured out and wrote his "Dialogue Concerning the Two Chief World Systems," he was at risk of waterboarding, or worse, by the Inquisition. Empirical evidence that challenges dogma must be dismissed. (See http://www.law.umkc.edu/faculty/projects/FTrials/galileo/dialogue.html.)

And yet Galileo's myth-breaking insights were themselves deeply flawed. The father of modern empirical research taught heliocentrism, although we know today that the sun is no more the center of the universe than the earth. Yet without the imperfect insights of Galileo (and those before him), where would we be today?

And so it goes with taxes and the tax cutting dogma in the face of empirical evidence. Flawed as it may be, there is mounting evidence that tax cuts are not pure good, raising issues that will retard human progress unless they are thoroughly examined with an eye toward reason, not faith, in financing civilization.

So to go back to the data on happiness, tax burdens, and the questions they provoke: Can higher taxes be associated with greater contentment despite conservative dogma? Can tax cuts cause misery? And could it be that regressive taxes may be a good thing, however much that challenges liberal dogma?

Another question worthy of examination is the role of taxes in mitigating risk. Economic development depends on understanding and minimizing risk. Failure to appreciate the nature of risk can have catastrophic consequences, as the whole world should understand from the meltdown of the financial system because of the mismeasure of risks.

In the 10 countries where people say they are happier than Americans, taxes are used to mitigate risks that are subject to little and sometimes no individual control.

Lose your job in America through no fault of your own, and what happens? You pay lower to no taxes, but you also see your income slashed, with more than a third of the jobless receiving no unemployment benefits, and some getting as little as five bucks a week. When the same thing happens in the 10 happier countries, the jobless benefits run as high as 90 percent of the income that was earned, often combined with training for a new job.

Get cancer, or hit by a stray bus or bullet, and in America you face ruin. If you are among the one in six Americans without health insurance, you may not get anything but emergency healthcare, arguably a kind of civil death sentence in the name of low taxes. Even if you have healthcare benefits and are not out ill or injured so long that you lose them, the benefits are unlikely to cover all of your costs, and so bankruptcy becomes a significant risk. In the 10 happier countries, your heathcare is not a function of employment or wealth or status, and chronic illnesses and injuries are treated as a social cost, a risk spread among everyone through taxes.

Have the good fortune to be born smart and the discipline to develop your brain in America, and you will face a new kind of tax on human capital, the rapidly rising costs of higher education, including tuition at so-called public institutions. In the 10 happier countries, college costs little out of pocket because it is seen as an investment that will be recouped through the taxes paid by a society made wealthier by nurturing its intellectual capital.

Have children in America and, if you are a woman, you get a few weeks of maternity pay. Have children in the 10 happier countries, and the government provides a range of benefits and, in Sweden and Norway, forces you to take time off work at nearly full pay so that your children are more likely to grow up emotionally secure, thus reducing the risk that they will become unproductive tax-eaters instead of taxpayers.

Grow old in America, and you will get meager benefits after paying about an eighth of your wages for Social Security, reducing your capacity to save in a 401(k) if you are lucky enough to have one or an IRA if you are not. Grow old in the 10 happier countries, and you will get larger benefits and without the need to save much.

Using taxes to mitigate risk and invest in young minds means less individual wealth, but it also means more time for family and leisure. The Swedes, for example, are more than three times more likely to own a boat than Americans.

Earth does not sit motionless midway between heaven and hell, with the sun and the stars revolving around it. These are ideas that we accept today but that just 377 years ago were enough to put you at risk of the iron maiden and resulted in lifetime house arrest for Galileo Galileo because he loved facts, even imperfect facts, more than dogma.

Tax cuts are not necessarily a good, however much the Washington establishments and its patrons wish it were so. It is high time we seriously examined the facts, especially inconvenient facts like the greater happiness reported by millions of people who pay more in taxes than Americans do.

Oprah Winfrey To Shoulder Audiences' Taxes For Australian Trip

September 17, 2010 8:31 a.m. EST

Anne Lu - AHN Entertainment Contributor

Los Angeles, CA, United States (AHN) - When Oprah Winfrey said her audience will get an all-expenses paid trip to Australia, they will get an all-expenses paid trip to Australia. The media mogul's very lucky audience won't be shelling out a single cent, including tax and passport fees, for their trip Down Under.

According to Larry Edema from Michigan, one of the 300 audiences set to fly with Oprah and pilot John Travolta later this year, Oprah hired a certified public accountant to address the tax issue after the show's taping.
He told TMZ that the CPA informed that that all taxes associated with the trip would be truly 100 percent free, and all expenses will be "handled by the Oprah show."
That includes all sightseeing costs and travel-related expenses, including passport costs for those who can't afford them.
But the 100 percent free tag doesn't include the government of New South Wales in Australia, which was handed a $2.7 million expense for Oprah and the gang's visit.
Oprah famously gave away brand new cars to all of her audience members in 2004, but it was laden with controversy after it was learned that the tax associated with the generous gift, around $7,000 each, would not be covered by the show.

Read more: http://www.allheadlinenews.com/articles/7019931927#ixzz0zvuaOdbq

SHOP TALK

Contested Historic Homers: What Are The Tax Consequences?

We have previously reported on the uncertain tax consequences that arise in connection with fans who catch historic home run balls, such as the widely publicized homers hit by Mark McGwire and Sammy Sosa during the 1998 season. See Shop Talk, "McGwire's 62nd Home Run: IRS Bobbles the Ball," 89 JTAX 253 (October 1998). Income and gift tax consequences may arise, depending on what the fan who catches the baseball does with it (e.g., returns it to the batter, donates it to charity, gives it to the Baseball Hall of Fame in Cooperstown, or keeps it). See Shop Talk, "More on Historic Homers: Is There 'Zero Basis' for Avoiding Taxable Income?," 89 JTAX 318 (November 1998).

As one might imagine, the tax law is not well developed in connection with the treatment of catching or finding immensely valuable sports memorabilia. In a widely publicized press release from then-IRS Commissioner Charles Rossotti (IR-98-56, 9/8/98), issued just hours before Mark McGwire's historic 62nd homer, the Commissioner acknowledged that the ball-catcher "would not have taxable income" *if* the ball were immediately returned "based on an analogy to principles of tax law that apply when someone *immediately* declines a prize or returns unsolicited merchandise" (emphasis added). The release further stated that there likewise would be no gift tax in these circumstances.

Little authority deals with the tax consequences of catching what is immediately an immensely valuable sports collectible. "Finding" the ball at one's feet (by no means a "clean" catch) is functionally similar to finding treasure, which has long been taxable under Section 61. See, e.g., *Cesarini*, 26 AFTR 2d 70-5107, 428 F2d 812, 70-2 USTC ¶9509 *Cesarini* . The "treasure" is taxable not when later converted into cash but rather as soon as the property is in the finder's "undisputed possession" (see Reg. 1.61-14(a)).

What are the tax consequences if the prize ball's possession is in fact bitterly disputed? The issue arose with respect to Sosa's 62nd home run in 1998, hit at Chicago's Wrigley Field, which initially resulted in a wild scramble with a violent mob, a police complaint, civil litigation, and a promise to return the ball to Sosa. ((The ball ultimately made it to the Hall of Fame, and currently is part of the Hall's "Baseball as America" traveling exhibition.) Sosa's 62nd home run ball, literally knocked out of the park, landed on Waveland Avenue. Gary "Moe" Mullins, a 47-year-old delivery driver who allegedly has been shagging baseballs outside Wrigley Field most of his life, claimed he had possession of the ball but it was then pried away from him (in an ensuing pile-up of fans) by one Brendon Cunningham, a suburban Chicago mortgage broker. Mullins filed a lawsuit against Cunningham to regain ownership, but due to mounting legal fees and a judge's requirement that he post a $50,000 bond, Mullins gave up and voluntarily dismissed his lawsuit. (See Brown, "Fan Drops Suit Over Sosa Home Run Ball," *Chicago Sun-Times*, 9/26/98, Metro section, page 9.)

In our November 1998 Shop Talk column, we concluded that the hapless Mullins should not be taxed on receipt of the ball, since his ownership was at best momentary and contested, and at worst nonexistent. In light of the reported facts he had neither dominion and control nor the benefits of ownership (although he apparently suffered the burdens of ownership, being physically assaulted in the war on Waveland, in the ensuing pile-up).

A similar situation involving Barry Bonds's record-setting 73rd home run ball hit on 10/7/01 was recently the result of a court decision involving two fans who claimed ownership after a brawl in the stands. According to reports, TV news video showed that Alex Popov had the ball in his glove for at least 0.6 seconds before he was mobbed by a crowd. One Patrick Hayashi ended up with the ball, and both Hayashi and Popov claimed ownership. In October 2001 Popov obtained a temporary restraining order, forbidding Hayashi from transferring or concealing the ball and ordering the ball placed in a safe deposit box requiring a minimum of two keys with the keys held by counsel for both parties, pending completion of the trial (*Popov v. Hayashi*, WL 31833731 *Popov v. Hayashi,*). Popov's complaint for injunctive relief, conversion, battery, assault, punitive damages, and constructive trust can be found online at

www.findlaw.com. The matter was litigated (Hayashi estimated his legal bills alone exceeded $100,000), and in court both sides agreed the videotape showed the ball in Popov's glove, but the parties couldn't agree on what defines "possession"—Popov's split-second catch or Hayashi's final grab. (See Stewart, "A Split-Decision on Bonds' Baseball," *Chicago Sun-Times,* 12/19/02, page 3.)

The court ruled that Popov had been "set upon by a gang of bandits, who dislodged the ball from his grasp," but made it clear that Hayashi had done nothing wrong and was not part of that gang. The court was assisted by four distinguished law professors who participated in a forum to discuss the legal definition of "possession" of the baseball (held during an official session of the court). After obtaining the lawyers' respective definitions of "possession," the court reportedly described a "gray area" between securely catching the ball and never touching it, and ruled that "the ball must be sold and the proceeds divided equally between the parties." This arose from the court's conclusion that the legal claims were of equal quality, and the parties were equally entitled to the ball, hence the concept of "equitable division." (King Solomon comes to baseball—perhaps only in California!)

The decision raises anew the question of tax consequences. If the ownership of the ball became taxable on the issuance of the court's decision, both litigants arguably recognized taxable income in 2002. Although the "treasure"—Bonds's baseball—was never literally reduced to the "undisputed possession" of either party by the court's ruling (see Reg. 1.61-14(a)), the Solomonic decision effectively is that each of the parties owns the sales proceeds from half of the baseball, as a matter of legal right.

If either (or both) of the litigants appeals the court's ruling, the matter will not be disposed of until 2003 (at the earliest). This arguably should postpone taxability of the event. Moreover, given the parties' right to appeal the ruling (which right would expire in early 2003), *query* whether such right effectively postpones taxation until this year when the court's determination becomes final, even if neither one appeals.

Several other issues which we raised in our prior Shop Talk columns also may be applicable here. And the Popov-Hayashi litigation brings to mind further questions:

- Are the legal fees and costs incurred by both litigants deductible, presumably under Section 212 (rather than Section 162)?
- Are they instead capitalized, and ultimately offset against the sales proceeds received by Popov and Hayashi, when the ball is ultimately sold? (Compare Prop. Reg. 1.263(a)-4; see Hardesty, "The New Proposed Regulations Under Section 263 on Capitalization of Intangibles," 98 JTAX 86 (February 2003).)
- If the receipt of the ball and the court's ruling are not a taxable event, do Popov and Hayashi retain a zero basis in the ball until the sale occurs?
- Could the ball qualify for capital gains treatment? If so, is it to Popov and Hayashi's advantage to have the sale occur at least 12 months and one day from the time they are deemed to become the respective owners of the ball (or the proceeds thereof)?
- When does their holding period start: on 10/7/01 (the date of Bonds's epic homer), the date of the court's initial opinion (12/18/02), the date the court's order becomes final and non-appealable, or some other date?

Conversely, if Popov and Hayashi must include the ball's value in taxable income before it is ultimately sold (and the value then determined by an arm's-length sale price), what value should they use during the interim for income tax reporting purposes? Last fall, experts in sports memorabilia sales reportedly said the ball could easily fetch more than $1 million at auction. See "Trial Begins Over Barry Bonds' 73rd Home Run Ball," 10/15/02 (AP/Internet). Indeed, a footnote in the court's opinion states that "it has been suggested that the ball might sell for something in excess of $1,000,000." There may be a substantial difference between the FMV of the ball at the time it was caught (or the time of the court's decision) and the ultimate auction price. See Shop Talk, "More on Historic Homers: Do Auction Prices Control?," 90 JTAX 189 (March 1999). Should the subsequent sales price be applied in hindsight?

Arguably not. (Valuation should be determined "without regard to subsequent illuminating events." See *Diehl*, 460 F Supp 1282, 76-2 USTC ¶9757 *Diehl,* , *aff'd per cur.* 43 AFTR 2d 79-495, 586 F2d 1080, 79-1 USTC ¶9146 .) We are sure that Messrs. Popov and Hayashi and their tax representatives are having a ball analyzing the alternatives!

Of course, sale of the ball requires the two sides to cooperate to find an auction house and then negotiate fees with the auction house, which could take more time and money, or else they could sell it on e-Bay. Experts already are raising doubts as to the value, in light of the court debacle. See Bean, "Who Wants to Buy a Baseball," Court TV, 1/14/03, at www.courttv.com. The court's December 18th decision imposed a December 30 deadline for an agreement as to how to implement the decision. The deadline came and went; the only thing Popov and Hayashi could agree on was to postpone the court order because they couldn't agree on how to sell the ball. See the Associated Press story, "Still No Resolution in Case of Bonds Ball," *Chicago Sun-Times,* 1/2/03, page 81.

Does the postponement into 2003 of the agreement on sales methodology affect the timing of income recognition? Will one of the parties appeal the California decision in any event? (No appeal was known to have been filed when this column was written.) Like Barry Bonds, we're having a "blast" with his 73rd homer, too!

I.R.C. § 139 Disaster relief payments.

(a) General rule. Gross income shall not include any amount received by an individual as a qualified disaster relief payment.

(b) Qualified disaster relief payment defined. For purposes of this section, the term "qualified disaster relief payment" means any amount paid to or for the benefit of an individual-

(1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster,

(2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster,

(3) by a person engaged in the furnishing or sale of transportation as a common carrier by reason of the death or personal physical injuries incurred as a result of a qualified disaster, or

(4) if such amount is paid by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare,

but only to the extent any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.

(c) Qualified disaster defined. For purposes of this section, the term "qualified disaster" means-

(1) a disaster which results from a terroristic or military action (as defined in section 692(c)(2)),

(2) a federally declared disaster (as defined by section 165(i)(5)(A)),

(3) a disaster which results from an accident involving a common carrier, or from any other event, which is determined by the Secretary to be of a catastrophic nature, or

(4) with respect to amounts described in subsection (b)(4) , a disaster which is determined by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance from the Federal, State, or local government or agency or instrumentality thereof.

(d) Coordination with employment taxes. For purposes of chapter 2 and subtitle C, qualified disaster relief payments and qualified disaster mitigation payments shall not be treated as net earnings from self-employment, wages, or compensation subject to tax.

(e) No relief for certain individuals. Subsections (a), (f), and (g) shall not apply with respect to any individual identified by the Attorney General to have been a participant or conspirator in a terroristic action (as so defined), or a representative of such individual.

(f) Exclusion of certain additional payments. Gross income shall not include any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act.

(g) Qualified disaster mitigation payments.

(1) In general. Gross income shall not include any amount received as a qualified disaster mitigation payment.

(2) Qualified disaster mitigation payment defined. For purposes of this section, the term "qualified disaster mitigation payment" means any amount which is paid pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act (as in effect on the date of the enactment of this subsection) or the National Flood Insurance Act (as in effect on such date) to or for the benefit of the owner of any property for hazard mitigation with respect to such property. Such term shall not include any amount received for the sale or disposition of any property.

(3) No increase in basis. Notwithstanding any other provision of this subtitle, no increase in the basis or adjusted basis of any property shall result from any amount excluded under this subsection with respect to such property.

(h) Denial of double benefit. Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed (to the person for whose benefit a qualified disaster relief payment or qualified disaster mitigation payment is made) for, or by reason of, any expenditure to the extent of the amount excluded under this section with respect to such expenditure.

United States v. Lewis

340 U.S. 590 (1951)

Mr. Justice BLACK delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment he returned approximately $11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though 'mistaken' belief that he was entitled to the whole bonus.

On the foregoing facts the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV—1 Cum. Bull. 179 (1936). The Court of Claims, however, relying on its own case, Greenwald v. United States, 57 F.Supp. 569, 102 Ct.Cl. 272, held that the excess bonus received 'under a mistake of fact' was not income in 1944 and ordered a refund based on a recalculation of that year's tax. 91 F.Supp. 1017, 1022, 117 Ct.Cl. 336. We granted certiorari, 340 U.S. 903, 71 S.Ct. 279, because this holding conflicted with many decisions of the courts of appeals, see, e.g., Haberkorn v. United States, 6 Cir., 173 F.2d 587, and with principles announced in North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197.

In the North American Oil case we said: 'If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' 286 U.S. at 424, 52 S.Ct. at page 615, 76 L.Ed. 1197. Nothing in this language permits an exception merely because a taxpayer is 'mistaken' as to the validity of his claim.

* * * Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C. ss 41, 42, 26 U.S.C.A. ss 41, 42; and see Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363, 51 S.Ct. 150, 151, 75 L.Ed. 383. The 'claim of right' interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, s 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer. Reversed.

Mr. Justice DOUGLAS (dissenting).

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later, however, it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.

Rev. Rul. 91-31

1991-1 C.B. 19

FACTS

In 1988, individual A borrowed $1,000,000 from C and signed a note payable to C for $1,000,000 that bore interest at a fixed market rate payable annually. A had no personal liability with respect to the note, which was secured by an office building valued at $1,000,000 that A acquired from B with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was $800,000 and the outstanding principal on the note was $1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to $800,000. The modified note bore adequate stated interest within the meaning of section 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) do not apply.

LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness. Section 1.61- 12(a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, 1982-2 C.B. 35, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer's residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under section 61(a)(12) of the Code, whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on United States v. Kirby Lumber Co., 284 U.S. 1 (1931), X-2 C.B. 356 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm's length transaction at less than their face amount.

In Commissioner v. Tufts, 461 U.S. 300 (1983), 1983-1 C.B. 120, the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. See section 1.1001-2(c), Example 7, of the Income Tax Regulations.

In Gershkowitz v. Commissioner, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of $250,000 for a $40,000 cash payment (rather than surrender of the $2,500 collateral) resulted in $210,000 of discharge of indebtedness income. The court, following the Tufts holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in Gershkowitz where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes $200,000 of discharge of indebtedness income in 1989 as a result of the modification of A's note payable to C.

In an earlier Board of Tax Appeals decision, Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer's gain or loss upon the sale of the property in a later year, held that the taxpayer's basis in the property

should have been reduced by the amount of the mortgage debt forgiven in the earlier year.

The Tufts and Gershkowitz decisions implicitly reject any interpretation of Fulton Gold that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. Fulton Gold, interpreted in this manner, is inconsistent with Tufts and Gershkowitz. Therefore, that interpretation is rejected and will not be followed.

HOLDING

The reduction of the principal amount of an under-secured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.

REV. RUL. 90-16, 1990-1 C.B. 12

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer's basis in satisfaction of a debt for which the taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under section 1001(c) and 61(a)(3) of the Internal Revenue Code?

FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, X obtained a loan from an unrelated bank. X was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of section 108(d)(3) of the Code) and defaulted on the debt. X negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released X from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000x dollars, X's adjusted basis in the subdivision was 8,000x dollars, and the amount due on the debt was 12,000x dollars, which did not represent any accrued but unpaid interest. After the transaction X was still insolvent.

LAW AND ANALYSIS

Sections 61(a)(3) and 61(a)(12) of the Code provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which section 108(a)(1)(B) applies, the amount excluded under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in section 108(d)(3)).

Section 1.61-6(a) of the Income Tax Regulations provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 1001 and the regulations thereunder.

Section 1001(a) of the Code provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.

Section 1001(b) of the Code provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) of the regulations provides that, except as provided in section 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). Example (8) under section 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its

fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 -- $6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under section 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under section 108(a)(1)(B) of the Code, the full amount of X's discharge of indebtedness income is excluded from gross income because that amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a 'disposition' within the scope of the gain or loss provisions of section 1001 of the Code. See Helvering v. Hammel, 311 U.S. 504 (1941), 1941-1 C.B. 375; Electro- Chemical Engraving Co. v. Commissioner, 311 U.S. 513 (1941), 1941-1 C.B. 380; and Danenberg v. Commissioner, 73 T.C. 370 (1979), acq., 1980-2 C.B. 1.

HOLDING

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under sections 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the subdivision transferred exceeds X's adjusted basis. Subject to the application of section 108 of the Code, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.

Estate of Levine v. Commissioner

634 F.2d 12 (2nd Cir. 1980)

FRIENDLY, Circuit Judge:

The estate of Aaron Levine and his widow Anna[1] appeal from a part of a decision of the Tax Court, 72 T.C. No. 68 (1979), which found a deficiency of $130,428.42 in Aaron Levine's 1970 income tax. The deficiency resulted from a determination by the Commissioner that the taxpayer had realized gain upon his gift, on January 1, 1970, of income producing property consisting of land and a building at 20-24 Vesey Street in New York City (the property) to a previously created trust for the benefit of three grandchildren.

The property was originally purchased on November 1, 1944, by a corporation wholly owned by Levine. On August 22, 1957, the corporation, which was in the course of dissolution, made a liquidating distribution of the property to the taxpayer. Thereafter Levine obtained two non-recourse mortgages secured by the property. One of these, for $500,000, was obtained on March 17, 1966, from the Bowery Savings Bank and represented the consolidation of numerous earlier mortgages.[2] The other, for $300,000, was obtained from the Commercial Trading Company on November 21, 1968; this was later amortized to $280,000.

Levine filed a gift tax return for 1970 reporting the transaction as follows:

20-24 Vesey Street, City, County and State of New York--		
Appraisal value		$925,000.00
Mortgages		
Bowery Savings Bank		$500,000.00
Interest accrued	12/1/69 to 12/31/69	2,291.67
Commercial Trading *		280,000.00
Interest accrued	12/1/69 to 12/31/69	3,616.67
		$785,908.34
Expenses incurred by donor in 1969 and assumed and paid by donee:		
Improvements		$117,716.53
Supplies		387.83
Repairs		1,253.93
Paint		63.60
Electricity		1,827.56
Steam		3,324.13
Total expenses		124,573.58
Total mortgages, interest and expenses		910,481.92
Equity		$ 14,518.08

* Between November 1968 and January 1970, $20,000 of the $300,000 principal was amortized.

and paid a gift tax on the equity of $14,518.08. The propriety of this was not challenged. However, the Commissioner assessed a deficiency in income tax on the ground that Levine had realized a gain in the amount of the excess of the total mortgages, interest and expenses aggregating $910,481.34, all of which were assumed by he donee, over Levine's adjusted basis, which, as increased by stipulation between the parties, was $485,429.55. The result was an excess of $425,051.79 and, upon application of capital gains rates, a deficiency of $130,428.42 in income tax. The Tax Court upheld the Commissioner largely on the authority of Crane v. C.I.R., 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), which had affirmed this court's decision, 153 F.2d 504 (1945) (L. Hand, J.). This appeal followed.

At first blush the layman and even the lawyer or judge not conditioned by exposure to tax law would find it difficult to understand how a taxpayer can realize $425,051.79 in gain by giving away property in which he possessed an equity of $14,518.08. Doubtless Mrs. Crane experienced a similar difficulty when she was held to have realized $275,500 (for a net taxable gain of $23,031.45), after she netted a mere $2,500 on the sale of an apartment building that she had inherited subject to a $255,000 mortgage and $7,042.50 in overdue interest payments, and had sold, under threat of foreclosure, subject to the same mortgage principal and $15,857.71 in defaulted interest payments. However, as stated in the ironic dictum of a distinguished tax practitioner's imaginary Supreme Court opinion,[3] "(e)veryday meanings are only of secondary importance when construing the words of a tax statute and are very seldom given any weight when a more abstruse and technical meaning is available."[4] In any event, Crane binds us whatever the yearnings of our untutored intuitions may be. What is more, few scholars quarrel with the wisdom of its holding, as distinguished from some of its language including the famous note 37, 331 U.S. at 14, 67 S.Ct. at 1054, of which more hereafter.

Instead of addressing himself directly to the ultimately dispositive question, what did Mrs. Crane receive, Chief Justice Vinson stated in his Crane opinion, 331 U.S. at 6, 67 S.Ct. at 1051, that "Logically, the first step . . . is to determine the unadjusted basis of the property . . . ." This must have struck Mrs. Crane as peculiar since she had claimed what would normally be the most favorable stance for the Commissioner in the determination of gain, namely, that her basis was zero. The answer to the Chief Justice's question lay in then s 113(a)(5), incorporated as modified in I.R.C. s 1014(a), which says that if property is acquired from a decedent the unadjusted basis is "the fair market value of such property at the time of such acquisition." On Mr. Crane's death the property had been appraised somewhat unscientifically one might guess as having exactly the value of the encumbrances, $262,042.50. If "property" as used in s 113(a) meant simply what the property was worth to Mrs. Crane, i. e., her "equity", her basis was zero, as she contended. However, Crane accepted the Commissioner's theory that since the term referred to "the land and buildings themselves, or the owner's rights in them, undiminished by the mortgage, the basis was the appraised value of $262,042.50."

The next step was to determine whether the unadjusted basis should be adjusted by deducting depreciation "to the extent allowed (but not less than the amount allowable)" as required by s 113(b)(1)(B), now incorporated as modified in I.R.C. s 1016(a)(2). Here again the parties took unconventional positions. Proceeding from her zero basis theory, Mrs. Crane maintained that no depreciation could be taken, although she had in fact taken

depreciation deductions totalling $25,500, 331 U.S. at 3 n.2, 67 S.Ct. at 1049. The Commissioner, true to his theory of basis, see ss 23(n) and 114(a) of the 1938 Act, now I.R.C. s 167(g), thought that depreciation deductions of $28,045.10 should have been taken, and the Court agreed.

"At last", said the Chief Justice, 331 U.S. at 12, "we come to the problem of determining the 'amount realized' on the 1938 sale." In fact the Court's answers to the two earlier questions had predetermined the answer to the dispositive one. If non-recourse mortgages contribute to the basis of property, then they must be included in the amount realized on its sale. Any other course would render the concept of basis nonsensical by permitting sellers of mortgaged property to register large tax losses stemming from an inflated basis and a diminished realization of gain. It would also permit depreciation deductions in excess of a property holder's real investment which could never subsequently be recaptured. Although the Court bolstered its holding by explicating the use of the word "property" in s 111(a) and (b) of the 1938 Act, now I.R.C. s 1001(a) and (b), and with certain other arguments, it was hardly necessary to go beyond the statement that "(i)f the 'property' to be valued on the date of acquisition is the property free of liens, the 'property' to be priced on a subsequent sale must be the same thing." (Footnote omitted.) 331 U.S. at 12.

Taxpayer argues that, be all this as it may, Crane is inapplicable because the transaction here was a gift and not a sale.

Apart from the general incongruity in finding that a gift yields a realized gain to the donor, petitioner argues that it is by no means clear how the Code's gross income, realization and recognition provisions apply to a donor's "gain" realized as incidental to a gift. Section 61(a)(3) defines gross income to include "(g)ains derived from dealings in property" a term seemingly broad enough to include gains from gifts. The same is true with respect to s 1001(a), which provides that "(t)he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . ." (Emphasis supplied). Apparent difficulty is encountered, however, when we come to the critical provision, s 1001(c), entitled "(r)ecognition of gain or loss", which states that "(e)xcept as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized." (Emphasis supplied).

Taxpayer suggests that the change in language from "other disposition of property" in s 1001(a), which seems broad enough to encompass a gift, but see United States v. Davis, 370 U.S. 65, 68-69 & n. 5, 82 S.Ct. 1190, 1192, 8 L.Ed.2d 335 (1962), to "sale or exchange" in s 1001(c), which would appear not to be so, postpones recognition of any "gain" realized in the instant transaction. This, he argues, is appropriate because while a sale or exchange results in the transferee's acquisition of a new basis, see s 1012, a gift ordinarily transfers the donor's basis plus any gift tax paid to the donee, s 1015, and tax on any gain can thus fairly be postponed until the donee engages in a taxable disposition. However, this argument overlooks "(t)he general rule . . . that when property is sold or otherwise disposed of, any gain realized must also be recognized, absent an appropriate nonrecognition provision in the Internal Revenue Code. (Footnote omitted.) King Enterprises v. United States, 418 F.2d 511, 514 (Ct.Cl.1969). See 3 Mertens, Federal Income Taxation, s 20.13 at 50 n. 4 (1980). A comparison of the present s 1001(c) with its pre-1976 predecessors, which, of course, are here controlling, suggests that s 1001(c)

merely limits nonrecognition to certain transactions described in detail elsewhere in the Code and does not confer it on all dispositions other than sales or exchanges.[8] However, we need not decide this question in view of our disposition of the case.

Levine relies also on the established principle that a gift of appreciated unmortgaged property does not give rise to a gain, even when deductions have been taken for business expenses which were necessary to the appreciation of the property. Campbell v. Prothro, 209 F.2d 331 (5 Cir. 1954). See also First National Industries, Inc. v. C.I.R., 404 F.2d 1182, 1183 (6 Cir. 1968), cert. denied, 394 U.S. 1014, 89 S.Ct. 1633, 23 L.Ed.2d 41 (1969); The Humacid Company v. C.I.R., 42 T.C. 894, 913 (1964). However, the transaction here in question was not a "pure" gift. The donee assumed not only the $785,908.34 in mortgages and accrued interest for which Levine was not personally liable but also the $124,573.58 of 1969 expenses, not constituting a lien, for which he was. If the donee had paid the latter sum directly to Levine, this case would clearly be governed by Crane since the donor would have received "boot". However, the assumption of another's legal obligation or debt is considered income under Old Colony Trust Co. v. C.I.R., 279 U.S. 716, 729, 49 S.Ct. 499, 504, 73 L.Ed. 918 (1929), and United States v. Hendler, supra, 303 U.S. at 566, 58 S.Ct. at 656. We can thus see no sound reason for reaching a result differing from that in Crane on the facts of this case.[9] We need not decide what the result should be if Levine had merely donated the property subject to non-recourse mortgages without an explicit "sale" element in this case, the donee's assumption of his 1969 personal liabilities.

. . . . This is not to say that we reject the broader analysis urged by the Commissioner and adopted by the Tax Court in this case, to wit, that Crane mandates that the transfer of property encumbered by any debt, non-recourse or personal, results in potentially taxable benefits even in the case of a "pure" gift.[11] We simply leave this benefit orientation and the other arguments advanced to another day. It is comforting to note, however, that an analysis of Levine's tax returns indicates his successful conversion of the appreciated value of the Vesey Street property into "benefits" at least as tangible as those in Crane.

The calculation of Levine's taxable gain, as found by the Tax Court, may be presented as follows:

(1) Amount realized	
(a) Expenses assumed by donee	$124,573.00
(b) Mortgages	780,000.00
(c) Interest payments assumed by donee	5,908.34
(d) Total	$910,481.34
(2) Less: Adjusted basis	
(a) Unadjusted basis[12]	$385,485.02
(b) Plus: Capital Improvements	334,452.00
(c) Improvements paid for by done	117,716.53
(d) Subtotal	837,743.55
(e) Less: Depreciation	352,314.00
(f) Adjusted basis	$485,429.55
(3) Gain	$425,051.79

[12] The record does not indicate Levine's unadjusted basis, but this can readily be calculated by subtracting capital improvements from, and adding depreciation deductions to, the stipulated adjusted basis of $485,429.55.

Of the total taxable gain of $425,051.79, the sum of $124,573.00 may be allocated directly to the 1969 expenses which Levine shifted to the donee trust. As was previously noted, these expenses are closely akin to the "boot" of $2,500 received by Mrs. Crane. In addition Levine's mortgage schedule, supra note 2, indicates that of the $780,000 in mortgages on the Vesey Street property at the time of its transfer, at least $235,044.23 derived from an outstanding mortgage which Levine acquired with the property in 1957, while the remaining $544,955.77 represents the net non-recourse indebtedness incurred during the period of Levine's ownership. As the table above indicates, $334,452 of the later amount was reinvested in capital improvements. Since the original mortgage of $235,044.23 must be assumed to have contributed toward Levine's unadjusted basis in the property, and the subsequent capital improvements adjusted Levine's basis upward by the extent of their value, $569,496.23 (or $235,044.23 🔑 $334,452.00) in basis credit derives solely from the non-recourse mortgages. Yet, upon disposition of the property in 1970 Levine's stipulated basis was merely $485,429.55. The shortfall between this and the aggregate contribution of the non-recourse mortgages, i. e., $84,066.68, can only be explained by depreciation deductions that Levine could not have taken but for the mortgages. Finally, there are two additional sources of "benefit" in this case with no analogue in Crane. One is the sum of $210,503.77 out of Levine's net borrowings of $544,955.77, see discussion supra, which was apparently not reinvested in capital improvements on the property, and which the taxpayer may thus be considered to have "pocketed". The second is the $5,908.34 in interest payments owed by the taxpayer but assumed by the donee.[14]

[14] The Commissioner in Crane did not include a similar sum of $15,857.71 in interest payments assumed by the buyer of the mortgaged property, see 331 U.S. at 4 n.6, 67 S.Ct. at 1050, apparently because interest due was a deductible item. This issue has not been raised before us.

Together, these four varieties of "benefit" sum exactly to what was found to be the taxpayer's total taxable income:

(a) Expenses assumed by donee	$124,573.00
(b) Depreciation resulting from non-recourse mortgages	84,066.68
(c) Pocketed mortgage funds	210,503.77
(d) Interest assumed by done	5,908.34
TOTAL	$425,051.79

To tax these "benefits" upon a disposition, at capital gains rates and without interest, is scarcely harsh. Failure to do so would mean, so far as we can see, that the $210,503.77 which the taxpayer obtained for his personal use by non-recourse loans against the appreciation of the property would never be taxed either as ordinary income or as gain (although, unless paid off by the donee, it would diminish any realization on the property), and that the benefits obtained by the depreciation deductions would remain untaxed unless and

until the donee sold the property, when they would operate as a reduction of the donee's adjusted basis which was passed on to the donee. In light of the seeming equity of the result reached, an otherwise similar case lacking the element of personal debt assumed by the donee might lead us to look with sympathy on the scant case law suggesting that the Crane principle may apply even to "pure" gifts, see Malone v. United States, 326 F.Supp. 106 (N.D.Miss.1971), aff'd, 455 F.2d 502 (5 Cir. 1972), even though a taxpayer could avoid application of Crane by withholding his beneficence until death. For reasons we have indicated, we simply do not find it necessary to decide that broader question on the facts here before us.

The judgment of the Tax Court is affirmed.

FIRST STEPS ON TIME VALUE

Dollars that are invested will give a return over time. It follows then that a dollar received early is worth more than a dollar received later. The earlier dollar will grow to be worth more than a dollar.

It follows also that dollars received at different times do not have the same real meaning (even if there were no inflation). They are like apples and oranges. Dollars received or paid at different times can not be compared or netted as if they were the same. One must first "translate" the earlier dollar into what it would be worth later, that is, take account of how much the earlier dollar would grow. Alternatively, one must first translate the later dollar into its equivalent at the earlier time. Conventionally dollars received or payable at different times are translated into either a "terminal value" or a "present value" before they are compared. Financial analysis does not, however, set a necessary time for comparing costs and benefits, but only insists on translation to a single time. Dollars received earlier than the point of comparison must be translated forward by taking into account the compound growth that is available; dollars received later than the point of comparison must be translated back by "discounting."

Translating forward: Compound growth. Growth is measured by the yardstick of compound returns because, for instance, investment returns received at the end of the year (or whatever the compounding period) are themselves an amount, which can be invested and would grow. There is a return earned on the return previously earned. For example, if we assume an initial investment of $100 in a municipal bond mutual fund paying tax-exempt interest at 10% per year, an initial investment of $100 will be worth $110 at the end of a year. For the second year the interest will be 10% of $110 or $11 and the total fund will grow to be worth $121. For the third year the interest will be 10% of $121 and the total fund will be $133.

The example can be generalized. The algebraic expression describing compound growth over period "n" of amount invested "P" (for principal) is

$$P(1+d)^n,$$

where investment of P will yield return rate "d". The expression is just a reflection of the fact that returns will themselves to earn money. Where a principal amount invested of "P" generates an after-tax return at rate "d," then "dP" would be earned by the end of the year and the investment would be worth P+Pd or P(1+d) at the end of the year. The second year's return would be computed on P(1+d), as if P(1+d) were a new investment or as if the return earned in the first year were withdrawn and then reinvested with the original P. Hence, the second year's return would be d[P(1+d)]. At the end of the second year, the total investment would be worth the sum of P(1+d) (its value at the end of the first year) plus the new interest of dP(1+d). The total of P(1+d) + d(P(1+d)) is the equivalent to P(1+d)(1+d) or simply $P(1+d)^2$. Similarly at the end of the third year the investment would be worth $P(1+d)^2 + dP(1+d)^2$ or simply $P(1+d)^3$. After a number of years "n", the investment would be worth $P(1+d)^n$.

Simple interest is mathematically simpler, but it is now considered "funny" interest. For simple interest you just multiply the principal P times the rate d, times the number of years n or Pdn. For instance at 10% simple, $100 will grow to $150 in 5 years. Simple interest is funny because it does not allow the earned interest to earn anything. Hence the principal is given first class ownership in that it earns a return, but the interest is given second class status in that it does not. If you can withdraw the interest, simple interest could be converted to compound growth simply by withdrawing the interest and putting it elsewhere.

Over short times, the difference between simple and compound growth is not all that dramatic and in the days before calculators the mathematics of exponents were formidable. In the long term the difference between simple and compound interest can be very dramatic. Over 25 years, $100 will grow to $350 with 10% simple interest ($250 of the $350 will be interest). With compound interest, $100 will grow to $100(1+10%)^{25} or $1,083, over three times as large. Two-thirds of the value comes from interest on the interest. With high returns (and calculators), simple interest that is neither withdrawable nor earning a return is considered to be a quite restricted kind of ownership, a funny concept, that must be measured by what the "real" or compound growth would be.

Translating back: "Discounting." "Discounting" or present value calculations are just the inverse of compound growth calculations. The present value of an amount A is the amount that will grow to equal A at given compound growth rates. The present value answers the questions, "How much must I put into an account yielding a known rate, if I need to have A by the end of n periods?" and "What is future amount A like in terms of having money in the bank now?" If, for instance, I need $133 in 3 years and get 10% tax exempt in my best investment, I can calculate that I must put $100 aside now: $100 will grow to equal $133 by the end of three years. So $133 in three years is like $100 now.

In general the present value of future amount A is

$\frac{A}{(1+d)n}$ since $\frac{A}{(1+d)n}$ will grow to equal $\frac{A}{(1+d)n} * (1+d)n$

or simply A in n years at return rate "d" compounded.

When "discounting" or computing a present value, the return rate is often called a "discount rate," but the discount rate is still just another way of looking at the availability of compound growth or interest.

PROBLEM A: Net Present Value.

A. An investor is given the choice of three investments. Investment A requires a $100 investment now; it will give $20 back at the end of two years and $110 back at the end of 5 years. Investment B requires a $100 investment now and will give $40 back at the end of the first, second and third years. Investment C requires an investment of $30 now and will give $55 back in a year, $20 back at the end of the next two years and then will require another $70 payment at the end of four years. To summarize, the cash flows from the investment are as follows:

Year	0	1	2	3	4	5
Investment A	($100)		$20			$110
Investment B	($100)	$40	$40	$40		
Investment C	($30)	$55	$20	$20	($70)	

1. Subtract cash invested from cash pulled out of each investment, *i.e.*, what is the total accounting profit? What is the rank order of the investments?

2. Assume the investor's best alternative return is 5% after-tax. What is the net present value of each of the investments? What is the rank order?

3. Assume the investor's best alternative return is 10% after-tax. What is the net present value of each of the investments? What is the rank order?

Why did the rank order change?

PROBLEM B: Future Value.

This problem demonstrates the difference between an immediate deduction of cost versus recovery of cost at the time that an asset is disposed of. Assume that your client has the option to invest in only one of two investments. Investment A requires the investor to invest $1,000 in land that can be sold at the end of 5 years for $1,800. The only tax required is at the time that the land is sold. Investment B allows your client to invest $1,000 in a research project. The project allows an immediate tax deduction in year 1 for the investment. At the end of 5 years, you will be able to sell your interest in the project for $1,610. Assume that the after-tax return is 10% for your investment of the tax savings. Assume that the tax rate on Investment A and Investment B is 35%. It appears that Investment A is a better investment because it provides a higher after-tax return, but Investment B provides more after-tax cash to your client. How much more?

Investment A: Since you cannot deduct the investment, the gain on investment in year 5 is a simple calculation of taking $1,800 less the investment of $1,000 and deriving the $800 profit in year 5. Your client pays 35% on this profit of $800 (or $280) leaving her with $1,520 after-tax.

Investment B is slightly more nuanced.

Step One: The tax deduction gives a tax benefit in year one of $350 of savings. ($1,000 deduction x 35% tax rate). What is the future value in 5 years of taking the $350 tax savings and investing it for 5 years with an after-tax return of 10%?

Step Two: Because the investment was immediately expensed, there is no remaining tax basis in the investment. So, the entire $1,610 is taxable without basis offset in year 5 for a tax cost of $563.5.

Step Three: $1,610 + FV of Savings in Step One –$563.5 (i.e., the Tax Cost in Step Two) = _____[solve]

Thus, Investment B is made better because of the tax rules even though the market gives Investment A $290 more pre-tax profits. The difference is all related to timing of the deduction.

NFL CONCUSSION SETTLEMENT

IN RE: NATIONAL FOOTBALL LEAGUE PLAYERS' CONCUSSION INJURY LITIGATION
No. 2:12-md-02323 (E.D. Pa.)

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Welcome to the NFL Concussion Settlement Program Website

A Settlement of a class action lawsuit was reached with the NFL and NFL Properties and retired NFL players, their representatives and family members. The retired NFL players sued, accusing the NFL of not warning players and hiding the damages of brain injury. On April 22, 2015, the United States District Court for the Eastern District of Pennsylvania entered a Final Order and Judgment approving this Settlement. The Settlement does not become effective unless no appeals are filed from that Final Order and Judgment within 30 days from that date, or if any appeals are timely filed, after those appeals are resolved in favor of the Settlement. You may check this website at any time for updates on the status of the Final Approval.

Class Members may sign up to receive future information by clicking "Sign Up for Future Information" below and providing your contact information or by calling 1-855-887-3485. There is no further action that a Class Member needs to take at this time to present a claim in the settlement. No claims for benefits can be submitted now and none have been submitted. No awards have been issued. If you are contacted by any person who is not a known and trusted source and who asserts that awards have been issued or who seeks information from you relating to a possible claim, you should not be influenced by the statements and should safeguard your personal information.

Retired players, legal representatives of incapacitated or deceased players, and families of deceased players may be eligible to receive benefits from this Settlement. A Class Member who opted out of the Settlement will not receive benefits.

The proposed settlement provides for three benefits:

1. Baseline medical exams for retired NFL players;
2. Monetary awards for diagnoses of ALS (Lou Gehrig's disease), Alzheimer's Disease, Parkinson's Disease, Dementia and certain cases of chronic traumatic encephalopathy or CTE (a neuropathological finding) diagnosed after death; and
3. Education programs and initiatives related to football safety.

All valid claims for injury will be paid in full for 65 years.

Retired players, their legal representatives and family members do not have to prove that the players' injuries were caused by playing NFL football to get money from the Settlement.

You will be able to register for benefits after the Settlement becomes effective, that is if no appeals are filed from that Final Order and Judgment, or if any appeals are timely filed, after those appeals are resolved in favor of the Settlement. If you would like information in the future when the registration period opens, click "Sign Up for Future Information" below and provide your contact information.

SIGN UP FOR FUTURE INFORMATION

See https://www.nflconcussionsettlement.com

MT. MORRIS DRIVE-IN THEATRE CO. v. COMMISSIONER

25 T.C. 272 (1955)

In 1947 petitioner purchased 13 acres of farm land located on the outskirts of Flint, Michigan, upon which it proceeded to construct a drive-in or outdoor theatre. Prior to its purchase by the petitioner the land on which the theatre was built was farm land and contained vegetation. The slope of the land was such that the natural drainage of water was from the southerly line to the northerly boundary of the property and thence onto the adjacent land, owned by David and Mary D. Nickola, which was used both for farming and as a trailer park. The petitioner's land sloped sharply from south to north and also sloped from the east downward towards the west so that most of the drainage from the petitioner's property was onto the southwest corner of the Nickolas' land. The topography of the land purchased by petitioner was well known to petitioner at the time it was purchased and developed. The petitioner did not change the general slope of its land in constructing the drive-in theatre, but it removed the covering vegetation from the land, slightly increased the grade, and built aisles or ramps which were covered with gravel and were somewhat raised so that the passengers in the automobiles would be able to view the picture on the large outdoor screen.

As a result of petitioner's construction on and use of this land rain water falling upon it drained with an increased flow into and upon the adjacent property of the Nickolas. This result should reasonably have been anticipated by petitioner at the time when the construction work was done.

The Nickolas complained to the petitioner at various times after petitioner began the construction of the theatre that the work resulted in an acceleration and concentration of the flow of water which drained from the petitioner's property onto the Nickolas' land causing damage to their crops and roadways. On or about October 11, 1948, the Nickolas filed a suit against the petitioner in the Circuit Court for the County of Genesee, State of Michigan, asking for an award for damages done to their property by the accelerated and concentrated drainage of the water and for a permanent injunction restraining the defendant from permitting such drainage to continue. Following the filing of an answer by the petitioner and of a reply thereto by the Nickolas, the suit was settled by an agreement dated June 27, 1950. This agreement provided for the construction by the petitioner of a drainage system to carry water from its northern boundary across the Nickolas' property and thence to a public drain. The cost

of maintaining the system was to be shared by the petitioner and the Nickolas, and the latter granted the petitioner and its successors an easement across their land for the purpose of constructing and maintaining the drainage system. The construction of the drain was completed in October 1950 under the supervision of engineers employed by the petitioner and the Nickolas at a cost to the petitioner of $8,224, which amount was paid by it in November 1950. The performance by the petitioner on its part of the agreement to construct the drainage system and to maintain the portion for which it was responsible constituted a full release of the Nickolas' claims against it. The petitioner chose to settle the dispute by constructing the drainage system because it did not wish to risk the possibility that continued litigation might result in a permanent injunction against its use of the drive-in theatre and because it wished to eliminate the cause of the friction between it and the adjacent landowners, who were in a position to seriously interfere with the petitioner's use of

its property for outdoor theatre purposes. A settlement based on a monetary payment for past damages, the petitioner believed, would not remove the threat of claims for future damages.

On its 1950 income and excess profits tax return the petitioner claimed a deduction of $822.40 for depreciation of the drainage system for the period July 1, 1950, to December 31, 1950. The Commissioner disallowed without itemization $5,514.60 of a total depreciation expense deduction of $19,326.41 claimed by the petitioner. In its petition the petitioner asserted that the entire amount spent to construct the drainage system was fully deductible in 1950 as an ordinary and necessary business expense incurred in the settlement of a lawsuit, or, in the alternative, as a loss, and claimed a refund of part of the $10,591.56 of income and excess profits tax paid by it for that year.

The drainage system was a permanent improvement to the petitioner's property, and the cost thereof constituted a capital expenditure.

The stipulation of facts and exhibits annexed thereto are incorporated herein by this reference.

OPINION. KERN, Judge:

When petitioner purchased, in 1947, the land which it intended to use for a drive-in theatre, its president was thoroughly familiar with the topography of this land which was such that when the covering vegetation was removed and graveled ramps were constructed and used by its patrons, the flow of natural precipitation on the lands of abutting property owners would be materially accelerated. Some provision should have been made to solve this drainage problem in order to avoid annoyance and harassment to its neighbors. If petitioner had included in its original construction plans an expenditure for a proper drainage system no one could doubt that such an expenditure would have been capital in nature.

Within a year after petitioner had finished its inadequate construction of the drive-in theatre, the need of a proper drainage system was forcibly called to its attention by one of the neighboring property owners, and under the threat of a lawsuit filed approximately a year after the theatre was constructed, the drainage system was built by petitioner who now seeks to deduct its cost as an ordinary and necessary business expenses, or as a loss.

We agree with respondent that the cost to petitioner of acquiring and constructing a drainage system in connection with its drive-in theatre was a capital expenditure.

Here was no sudden catastrophic loss caused by a 'physical fault' undetected by the taxpayer in spite of due precautions taken by it at the time of its original construction work as in American Bemberg Corporation, 10 T.C. 361; no unforeseeable external factor as in Midland Empire Packing Co., 14 T.C. 635; and no change in the cultivation of farm property caused by improvements in technique and made many years after the property in question was put to productive use as in J. H. Collingwood, 20 T.C. 937. In the instant case it was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner's capital investment was incomplete. In addition, it should be emphasized that here there was no mere restoration or rearrangement of the original capital asset, but there was the acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system.

That this drainage system was acquired and constructed and that payments therefor were made in compromise of a lawsuit is not determinative of whether such payments were ordinary and necessary business expenses or capital expenditures. 'The decisive test is still the character of the transaction which gives rise to the payment.' Hales-Mullaly v. Commissioner, 131 F.2d 509, 511, 512.

In our opinion the character of the transaction in

the instant case indicates that the transaction was a capital expenditure. Decision will be entered for the respondent.

RAUM, J. concurring: The expenditure herein was plainly capital in nature, and, as the majority opinion points out, if provision had been made in the original plans for the construction of a drainage system there could hardly be any question that its cost would have been treated as a capital outlay. The character of the expenditure is not changed merely because it is made at a subsequent time, and I think it wholly irrelevant whether the necessity for the drainage system could have been foreseen, or whether the payment therefor was made as a result of the pressure of a law suit. FISHER, J., agrees with this concurring opinion.

RICE, J. dissenting: It seems to me that J. H. Collingwood, 20 T.C. 937 (1953), Midland Empire Packing Co., 14 T.C. 635 (1950), American Bemberg Corporation, 10 T.C. 361 (1948), aff'd. 177 F.2d 200 (C.A. 1949), and Illinois Merchants Trust Co., Executor, 4 B.T.A. 103 (1926), are ample authority for the conclusion that the expenditure which petitioner made was an ordinary and necessary business expense, which did not improve, better, extend, increase, or prolong the useful life of its property. The expenditure did not cure the original geological defect of the natural drainage onto the Nickolas' land, but only dealt with the intermediate consequence thereof. The majority opinion does not distinguish those cases adequately. And since those cases and the result reached herein do not seem to me to be able to 'live together,' I cannot agree with the majority that the expenditure here was capital in nature. OPPER, JOHNSON, BRUCE, and MULRONEY, JJ., agree with this dissent.

Mt. Morris Drive-In Theate Company v. Commissioner

238 F.2d 85 (6th Cir. 1956)

Before SIMONS, Chief Judge, and ALLEN and McALLISTER, Circuit Judges.

PER CURIAM. The above cause is affirmed for the reasons given in the memorandum opinion of the Tax Court. The drainage system there involved we think was a capital improvement. There is substantial evidence that it added to the value of the petitioner's land for the use to which it had been put; that it is immaterial that that increase in value was not by evidence measured in dollars, and that the inferences of the Tax Court could be and were drawn from the physical configuration of the land and what it had been necessary to do to establish thereon the Drive-In Theatre which the petitioner erected thereon. The decision of the Tax Court is affirmed.

McALLISTER, Circuit Judge (dissenting).

It appears clear to me that the finding of the Tax Court that the drainage system in question was a permanent improvement to petitioner's property was unsupported by the evidence. If it had not been for the action brought against petitioner by the Nickolas' for damages to their property because of the alleged conduct of petitioner in increasing the drainage of rainfall upon their land, petitioner would never have thought of constructing a drain; and if it had paid $8,224 to the Nickolas' in settlement of their suit or claims for past, present, and future damages resulting from such increased drainage of water, such payment could not be considered as an expenditure for a permanent improvement to increase the value of its property, or, as the Tax Court found, 'a permanent improvement to petitioner's property.' There is no difference between the construction of the drain by petitioner and the payment to the Nickolas' of the amount required for its construction. I therefore concur with the minority opinion of the Tax

Court and accordingly am of the view that the decision should be reversed.

MIDLAND EMPIRE PACKING COMPANY v. COMMISSIONER

14 T.C. 635 (1950)

ARUNDELL, Judge:

The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under section 23(a) of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section 23(f) of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss. . . . [Reg. §1.162-4] is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In Illinois Merchants Trust Co., Executor, 4 B.T.A. 103, at page 106, we discussed this subject in some detail and in our opinion said:

> It will be noted that the first sentence of the article (now Regulations 111, sec. 29.23(a)-4) relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind that purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

It will be seen from our findings of fact that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oilproof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years

prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

While it is conceded on brief that the expenditure was 'necessary,' respondent contends that the encroachment of the oil nuisance on petitioner's property was not an 'ordinary' expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of 'ordinary' for, as stated in Welch v. Helvering, 290 U.S. 111, 'ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. * * * the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part.' Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

In American Bemberg Corporation, 10 T.C. 361, we allowed as deductions, on the ground that they were ordinary and necessary expenses, extensive expenditures made to prevent disaster, although the repairs were of a type which had never been needed before and were unlikely to recur. In that case the taxpayer, to stop cave-ins of soil which were threatening destruction of its manufacturing plant, hired an engineering firm which drilled to the bedrock and injected grout to fill the cavities were practicable, and made incidental replacements and repairs, including tightening of the fluid carriers. . . . We found that the cost (other than replacement) of this [drilling and grout] program did not make good the depreciation previously allowed, and stated in our opinion:

> [The] program was intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before.

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations. In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner's alternative contention that the expenditure is deductible as a business loss. . . .

Rev. Rul. 2001-4, 2001-3 I.R.B. 295, 2001-1 C.B. 295

AIRCRAFT MAINTENANCE COSTS

ISSUE

Are costs incurred by a taxpayer to perform work on its aircraft airframe, including the costs of a "heavy maintenance visit," deductible as ordinary and necessary business expenses under § 162 of the Internal Revenue Code, or must they be capitalized under §§ 263 and 263A?

FACTS

X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its operating license and airworthiness certification for these aircraft, X is required by the Federal Aviation Administration "FAA" to establish and adhere to a continuous maintenance program for each aircraft within its fleet. * * * The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. The most extensive of these for X is termed a "heavy maintenance visit" * * * which is required to be performed by X approximately every eight years of aircraft operation. The purpose of a heavy maintenance visit, according to X's maintenance manual, is to prevent deterioration of the inherent safety and reliability levels of the aircraft equipment and, if such deterioration occurs, to restore the equipment to their inherent levels.

In each of the following three situations, X reasonably anticipated at the time the aircraft was placed in service that the aircraft would be useful in its trade or business for up to 25 years, taking into account the repairs and maintenance necessary to keep the aircraft in an ordinarily efficient operating condition.***

Situation 1

In 2000, X incurred $2 million for the labor and materials necessary to perform a heavy maintenance visit on the airframe of Aircraft 1, which X acquired in 1984 for $15 million (excluding the cost of engines). To perform the heavy maintenance visit, X extensively disassembled the airframe, removing items such as its engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. * * * X also performed additional work as part of the heavy maintenance visit for Aircraft 1. This work included applying corrosion prevention and control compounds; stripping and repainting the aircraft exterior; and cleaning, repairing, and painting airframe interior items such as seats, carpets, baggage stowage bins, ceiling and sidewall panels, lavatories, galleys, and passenger service units. * * *

None of the work performed by X as part of the heavy maintenance visit * * * for Aircraft 1 resulted in a material upgrade or addition to its airframe or involved the replacement of any (or a significant portion of any) major component or substantial structural part of the airframe. This work maintained the relative value of the aircraft. The value of the aircraft declines as it ages even if the heavy maintenance work is performed.

After 45 days, the heavy maintenance visit was completed, and Aircraft 1 was reassembled, tested, and returned to X's fleet. X then continued to use Aircraft 1 for the same purposes and in the same manner that it did prior to the performance of the heavy maintenance visit. The performance of the heavy maintenance visit did not extend the useful life of the airframe beyond the 25-year useful life that X anticipated when it acquired the airframe.

Situation 2

Also in 2000, X incurred costs to perform work in conjunction with a heavy maintenance visit on the airframe of Aircraft 2. The heavy maintenance visit on Aircraft 2 involved all of the same work described in Situation 1. In addition, X found significant wear and corrosion of fuselage skins of Aircraft 2 that necessitated more extensive work than was performed on Aircraft 1. Namely, X decided to remove all of the skin panels on the belly of Aircraft 2's fuselage and replace them

with new skin panels. The replaced skin panels represented a significant portion of all of the skin panels of Aircraft 2, and the work performed materially added to the value of the airframe.

Because Aircraft 2 was already out of service and its airframe disassembled for the heavy maintenance visit, X also performed certain modifications to the airframe. These modifications involved installing a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight.

Situation 3

Also in 2000, X decided to make substantial improvements to Aircraft 3, which was 22 years old and nearing the end of its anticipated useful life, for the purpose of increasing its reliability and extending its useful life. X's improvement of Aircraft 3 involved many modifications to the structure, exterior, and interior of the airframe. The modifications included removing all the belly skin panels on the aircraft's fuselage and replacing them with new skin panels; replacing the metal supports under the lavatories and galleys; removing the wiring in the leading edges of both wings and replacing it with new wiring; removing the fuel tank bladders, harnesses, wiring systems, and connectors and replacing them with new components; opening every lap joint on the airframe and replacing the epoxy and rivets used to seal the lap joints with a non-corrosive sealant and larger rivets; reconfiguring and upgrading the avionics and the equipment in the cockpit; replacing all the seats, overhead bins, sidewall panels, partitions, carpeting, windows, galleys, lavatories, and ceiling panels with new items; installing a cabin smoke and fire detection system, and a ground proximity warning system; and painting the exterior of the aircraft. * * *

In order to upgrade the airframe to the desired level, X performed much of the same work that would be performed during a heavy maintenance visit (as described in Situation 1). The result of the work performed on Aircraft 3 was to materially increase the value of the airframe and substantially prolong its useful life.

LAW

Section 162 and § 1.162-1(a) of the Income Tax Regulationsallow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including “incidental repairs.”

Section 1.162-4 allows a deduction for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. However, § 1.162-4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with § 167.

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. See also§ 1.263(a)-1(a).

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. However, that regulation also provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of § 162 and §1.162-4 are not capital expenditures under §1.263(a)-1.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(g)(1) provides that, for purposes of § 263A, the term “produce” includes construct, build, install, manufacture, develop, or improve.

The United States Supreme Court has specifically recognized that the “decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind,” and a careful examination of the particular facts of each case is required. Deputy v. du Pont, 308 U.S. 488, 496 (1940), quoting Welch v. Helvering, 290 U.S. 111, 114 (1933). To determine whether certain costs should be classified as capital expenditures or as repair and maintenance expenses, “it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made.”American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376 (1948), aff'd, 177 F.2d 200 (6th Cir. 1949).

Any properly performed repair, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to that repair. Consequently, courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), acq., V-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In Estate of Walling v. Commissioner, 373 F.2d 190, 192-193 (3rd Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to “put” or “keep” property in ordinary efficient operating condition. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), nonacq. on other grounds, 1964-2 C.B. 8., the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property. The Supreme Court's decision in INDOPCO Inc. v. Commissioner, 503 U.S. 79 (1992) does not affect these general principles. SeeRev. Rul. 94-12, 1994-1 C.B. 36;Ingram Industries, Inc. v. Commissioner, T.C.M. 2000-323.

Even if the expenditures include the replacement of numerous parts of an asset, if the replacements are a relatively minor portion of the physical structure of the asset, or of any of its major parts, such that the asset as whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repairs or maintenance expenses. * * *

If, however, a major component or a substantial structural part of the asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. * * *

In addition, although the high cost of the work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. * * *

Similarly, the fact that a taxpayer is required by a regulatory authority to make certain repairs or to perform certain maintenance on an asset in order to continue operating the asset in its business does not mean that the work performed materially increases the value of such asset, substantially prolongs its useful life, or adapts it to a new use. * * *

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are

questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. Id. at 690.The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. See Moss v. Commissioner, 831 F.2d 833, 842 (9th Cir. 1987); * * *

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. * * *

On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. * * *

ANALYSIS

In Situation 1, the heavy maintenance visit on Aircraft 1 primarily involved inspecting, testing, servicing, repairing, reconditioning, cleaning, stripping, and repainting numerous airframe parts and components. The heavy maintenance visit did not involve replacements, alterations, improvements, or additions to the airframe that appreciably prolonged its useful life, materially increased its value, or adapted it to a new or different use. Rather, the heavy maintenance visit merely kept the airframe in an ordinarily efficient operating condition over its anticipated useful life for the uses for which the property was acquired. * * * The fact that the taxpayer was required to perform the heavy maintenance visit to maintain its airworthiness certificate does not affect this determination. * * *

Although the heavy maintenance visit did involve the replacement of numerous airframe parts with new parts, none of these replacements required the substitution of any (or a significant portion of any) major components or substantial structural parts of the airframe so that the airframe as a whole increased in value, life expectancy, or use. * * * Thus, the costs of the heavy maintenance visit constitute expenses for incidental repairs and maintenance under §1.162-4.

Finally, the costs of the heavy maintenance visit are not required to be capitalized under §§ 263 or 263A as part of a plan of rehabilitation, modernization, or improvement to the airframe. Because the heavy maintenance visit involved only repairs for the purpose of keeping the airframe in an ordinarily efficient operating condition, it did not include the type of substantial capital improvements necessary to trigger the plan of rehabilitation doctrine. * * * Accordingly, the costs incurred by X for the heavy maintenance visit in Situation 1 may be deducted as ordinary and necessary business expenses under §162.

In Situation 2, in addition to performing all of the work described in Situation 1 on Aircraft 2, X replaced all of the skin panels on the belly of the fuselage and installed a cabin smoke and fire detection and suppression system, a ground proximity warning system and an air phone system. Because the replacement of the skin panels involved replacing a significant portion of the airframe's skin panels (which in the aggregate represented a substantial structural part of the airframe) thereby materially adding to the value of and improving the airframe, the cost of replacing the skin panels must be capitalized. * * * In addition, the additions and upgrades to Aircraft 2 in the form of the fire protection, air phone, and ground proximity warning systems must be capitalized because they materially improved the airframe. * * * Accordingly, the costs incurred by X for labor and materials allocable to these capital improvements must be treated as capital expenditures under § 263. * * *

Further, the mere fact that these capital improvements were made at the same time that the work described in Situation 1 was performed on Aircraft 2 does not require capitalization of the cost of the heavy maintenance visit under the plan of rehabilitation doctrine. Whether a general plan of rehabilitation exists is a question of fact to be determined based on all the facts and

circumstances. * * * X's plan in Situation 2 was not to rehabilitate Aircraft 2, but merely to perform discrete capital improvements to the airframe. * * * Accordingly, the costs of the work described in Situation 1 are not part of a general plan of rehabilitation, modernization, or improvement to the airframe. The costs incurred by X for the work performed on Aircraft 2 must be allocated between capital improvements, which must be capitalized under §§ 263 and 263A, and repairs and maintenance, which may be deducted under § 162.

In Situation 3, X is required to capitalize under § 263 the costs of all the work performed on Aircraft 3. The work in Situation 3 involved replacements of major components and significant portions of substantial structural parts that materially increased the value and substantially prolonged the useful life of the airframe. * * * In addition, the value of Aircraft 3 was materially increased as a result of material additions, alterations and upgrades that enabled X to operate Aircraft 3 in an improved way. * * * In contrast to Situation 1, the extensiveness of the work performed on Aircraft 3 constitutes a restoration within the meaning of §263(a)(2). * * * X performed much of the same work on Aircraft 3 that would be performed during a heavy maintenance visit (as described in Situtation 1) ("Situation 1-type work"). Although these costs, standing alone, generally are deductible expenses under § 162, in this context, they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the airframe of Aircraft 3 and X is required to capitalize under §§ 263 and 263A the costs of that work. * * * In this situation, X planned to perform substantial capital improvements to upgrade the airframe of Aircraft 3 for the purpose of increasing its reliability and extending its useful life. * * * The Situation 1-type work was incidental to X's plan to upgrade Aircraft 3. * * * The effect of all the work performed on Aircraft 3, including the inspection, repair, and maintenance items, is to materially increase the value of the airframe and substantially prolong its useful life. Thus, all the work performed by X on Aircraft 3 is part of a general plan of rehabilitation, modernization, and improvement to the airframe and the costs associated with this work must be capitalized under § 263. * * *

The conclusions in this ruling would be the same whether X transported only freight or only passengers.

NICKERSON v. COMMISSIONER

700 F.2d 402 (7th Cir. 1983)

PELL, Circuit Judge.

Petitioners appeal the judgment of the United States Tax Court finding that profit was not their primary goal in owning a dairy farm. Based on this finding the tax court disallowed deductions for losses incurred in renovating the farm. The sole issue presented for our review is whether the tax court's finding regarding petitioners' motivation was clearly erroneous.

I. Facts

Melvin Nickerson (hereinafter referred to as petitioner) was born in 1932 in a farming community in Florida. He worked evenings and weekends on his father's farm until he was 17. Petitioner entered the field of advertising after attending college and serving in the United States Army. During the years relevant to this case he was self-employed in Chicago, serving industrial and agricultural clients. His wife, Naomi W. Nickerson, was a full-time employee of the Chicago Board of Education. While petitioners were not wealthy, they did earn a comfortable living.

At the age of forty, petitioner decided that his career in the "youth oriented" field of advertising would not last much longer, and he began to look for an alternative source of income for the future. Petitioners decided that dairy farming was the most desirable means of generating income and examined a number of farms in Michigan and Wisconsin. After several years of searching, petitioners bought an 80-acre farm in Door County, Wisconsin for $40,000. One year later they purchased an additional 40 acres adjoining the farm for $10,000.

The farm, which had not been run as a dairy for eight years, was in a run-down condition. What little equipment was left was either in need of repair or obsolete. The tillable land, about 60 acres, was planted with alfalfa, which was at the end of its productive cycle. In an effort to improve this state of affairs petitioners leased the land to a tenant-farmer for $20 an acre and an agreement that the farmer would convert an additional ten acres a year to the cultivation of a more profitable crop. At the time of trial approximately 80 acres were tillable. The rent received from the farmer was the only income derived from the farm.

Petitioner visited the farm on most weekends during the growing season and twice a month the rest of the year. Mrs. Nickerson and the children visited less frequently. The trip to the farm requires five hours of driving from petitioners' home in Chicago. During these visits petitioner and his family either worked on their land or assisted neighboring farmers. When working on his own farm petitioner concentrated his efforts on renovating an abandoned orchard and remodeling the farm house. In addition to learning about farming through this experience petitioner read a number of trade journals and spoke with the area agricultural extension agent.

Petitioners did not expect to make a profit from the farm for approximately 10 years. True to their expectations, petitioners lost $8,668 in 1976 and $9,872.95 in 1977. Although they did not keep formal books of account petitioners did retain receipts and cancelled checks relating to farm expenditures. At the time of trial, petitioners had not yet acquired any livestock or farm machinery. The farm was similarly devoid of recreational equipment and had never been used to entertain guests.

The tax court decided that these facts did not support petitioners' claim that the primary goal in operating the farm was to make a profit. We will examine the tax court's reasoning in more detail after setting out the relevant legal considerations.

II. The Statutory Scheme

Section 162(a) of the Internal Revenue Code of 1954 allows deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 183, however, limits the availability of these deductions if

the activity "is not engaged in for profit" to deductions that are allowed regardless of the existence of a profit motive and deductions for ordinary and necessary expenses "only to the extent that the gross income derived from such activity for the taxable year exceeds [otherwise allowable deductions]." I.R.C. § 183(b)(2). The deductions claimed by petitioners are only allowable if their motivation in investing in the farm was to make a profit.

Petitioners bear the burden of proving that their primary purpose in renovating the farm was to make a profit.[1] In meeting this burden, however, "it is sufficient if the taxpayer has a bona fide expectation of realizing a profit, regardless of the reasonableness of such expectation." Although petitioners need only prove their sincerity rather than their realism the factors considered in judging their motivation are primarily objective. In addition to the taxpayer's statements of intent, which are given little weight for obvious reasons, the tax court must consider "all facts and circumstances with respect to the activity," including the following:

> (1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit....
>
> (2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices....
>
> (3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on the activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit.... The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.
>
> (4) *Expectation that assets used in activity may appreciate in value*....
>
> (5) *The success of the taxpayer in carrying on other similar or dissimilar activities*....
>
> (6) *The taxpayer's history of income or losses with respect to the activity*....
>
> (7) *The amount of occasional profits, if any, which are earned*....
>
> (8) *The financial status of the taxpayer*....
>
> (9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits....

Treas.Reg. § 1.183–2(b)(1)–(9). None of these factors is determinative, nor is the decision to be made by comparing the number of factors that weigh in the taxpayer's favor with the number that support the Commissioner. Id. There is no set formula for divining a taxpayer's true motive, rather "[o]ne struggles in vain for any verbal formula that will supply a ready touchstone. The standard set by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Welch v. Helvering, 290 U.S. 111, 115, 54 S.Ct. 8, 9, 78 L.Ed. 212 (1933). Nonetheless, we are given some guidance by the enumerated factors and by the Congressional purpose in enacting §183.

> The legislative history surrounding section 183 indicates that one of the prime motivating factors behind its

> passage was Congress' desire to create an objective standard to determine whether a taxpayer was carrying on a business for the purpose of realizing a profit or was instead merely attempting to create and utilize losses to offset other income. Jasionowski v. Commissioner, 66 T.C. 312, 321 (1976).

Congressional concern stemmed from a recognition that "[w]ealthy individuals have invested in certain aspects of farm operations solely to obtain 'tax losses'—largely bookkeeping losses—for use to reduce their tax on other income.... One of the remarkable aspects of the problem is pointed up by the fact that persons with large nonfarm income have a remarkable propensity to lose money in the farm business." S.Rep. No. 91–552,91st Cong., 1st Sess., *reprinted in* 1969 U.S.Code Cong. & Ad.News 2027, 2376. With this concern in mind we will now examine the decision of the tax court.

III. Decision of the Tax Court

The tax court analyzed the relevant factors and determined that making a profit was not petitioners' primary goal in engaging in farming. The court based its decision on a number of factors that weighed against petitioners. The court found that they did not operate the farm in a businesslike manner and did not appear to have a concrete plan for improving the profitability of the farm. The court believed that these difficulties were attributable to petitioners' lack of experience, but did not discuss the steps actually taken by Melvin Nickerson to gain experience in farming.

The court found it difficult to believe that petitioners actually believed that the limited amount of time they were spending at the farm would produce a profit given the dilapidated condition of the farm. Furthermore, the court found that petitioners' emphasis on making the farm house habitable rather than on acquiring or repairing farm equipment was inconsistent with a profit motive. These factors, combined with the consistent history of losses borne by petitioners, convinced the court that "petitioner at best entertains the hope that when he retires from the advertising business and can devote his complete attention to the farming operation, he may at that time expect to produce a profit." The court did not think that this hope rose to the level of a bona fide expectation of profit.

IV. Review of the Tax Court's Findings

Whether petitioners intended to run the dairy farm for a profit is a question of fact, and as such our review is limited to a determination of whether the tax court was "clearly erroneous" in determining that petitioners lacked the requisite profit motive. * * * * This standard of review applies although the only dispute is over the proper interpretation of uncontested facts. * * * * This is one of those rare cases in which we are convinced that a mistake has been made.

Our basic disagreement with the tax court stems from our belief that the court improperly evaluated petitioners' actions from the perspective of whether they sincerely believed that they could make a profit from their current level of activity at the farm. On the contrary, petitioners need only prove that their current actions were motivated by the expectation that they would later reap a profit, in this case when they finished renovating the farm and began full-time operations. It is well established that a taxpayer need not expect an immediate profit; the existence of "start up" losses does not preclude a bona fide profit motive.* * * * We see no basis for distinguishing petitioners' actions from a situation in which one absorbs larger losses over a shorter period of time by beginning full-time operations immediately. In either situation the taxpayer stands an equal chance of recouping start-up losses. In fact, it seems to us a reasonable decision by petitioners to prepare the farm before becoming dependent upon it for sustenance. Keeping in mind that petitioners were not seeking to supplement their existing incomes with their current work on the farm, but rather were laying the ground work for a contemplated career switch, we will examine the factors relied upon by the tax court.

The tax court found that the amount of time petitioners devoted to the farm was inadequate. In reaching this conclusion the court ignored petitioners' agreement with the tenant-farmer under which he would convert 10 acres a year to profitable crops in exchange for the right to farm the land. In this situation the limited amount of time spent by petitioners, who were fully employed in Chicago, is not inconsistent with an expectation of profit. * * * *

The court also rested its decision on the lack of a concrete plan to put the farm in operable condition. Once again, this ignores petitioners' agreement with the tenant-farmer concerning reclamation of the land. Under this agreement the majority of the land would be tillable by the time petitioners were prepared to begin full-time farming. The tax court also believed that petitioners' decision to renovate the farm house and orchard prior to obtaining farm equipment evidenced a lack of profit motive. As petitioners planned to live on the farm when they switched careers refurbishing the house would seem to be a necessary first step. The court also failed to consider the uncontradicted testimony regarding repairs made to the hay barn and equipment shed, which supported petitioners' contention that they were interested in operating a farm rather than just living on the land. Additionally, we fail to understand how renovating the orchard, a potential source of food and income, is inconsistent with an expectation of profit.

The tax court took into account the history of losses in considering petitioners' intentions. While a history of losses is relevant, in this case little weight should be accorded this factor. Petitioners did not expect to make a profit for a number of years, and it was clear from the condition of the farm that a financial investment would be required before the farm could be profitable. * * * *

The court believed that most of petitioners' problems were attributable to their lack of expertise. While lack of expertise is relevant, efforts at gaining experience and a willingness to follow expert advice should also be considered. Treas.Reg. 1.183–2(b)(2). The court here failed to consider the uncontradicted evidence that Melvin Nickerson read trade journals and Government-sponsored agricultural newsletters, sought advice from a state horticultural agent regarding renovation of the orchard and gained experience by working on neighboring farms. In addition, petitioners' agreement with the tenant-farmer was entered into on the advice of the area agricultural extension agent. To weigh petitioners' lack of expertise against them without giving consideration to these efforts effectively precludes a bona fide attempt to change careers. We are unwilling to restrict petitioners in this manner and believe that a proper interpretation of these facts supports petitioners' claims.

The tax court recognized that the farm was not used for entertainment and lacked any recreational facilities, and that petitioners' efforts at the farm were "prodigious," but felt that this was of little importance. While the Commissioner need not prove that petitioners were motivated by goals other than making a profit, we think that more weight should be given to the absence of any alternative explanation for petitioners' actions. As we previously noted the standard set out by the statute is to be applied with the insight gained from a lifetime of experience as well as an understanding of the statutory scheme. Common sense indicates to us that rational people do not perform hard manual labor for no reason, and if the possibility that petitioners performed these labors for pleasure is eliminated the only remaining motivation is profit. * * * *

If this were a case in which wealthy taxpayers were seeking to obtain tax benefits through the creation of paper losses we would hesitate to reverse. Before us today, however, is a family of modest means attempting to prepare for a stable financial future. The amount of time and hard work invested by petitioners belies any claim that allowing these deductions would thwart Congress's primary purpose, that of excluding "hobby" losses from permissible deductions. Accordingly, we hold that the tax court's finding was clearly erroneous and reversed.

PLUNKETT v. COMMISSIONER

47 T.C.M. 1439 (1984)

GOFFE, Judge:

Petitioner H. Connely Plunkett is an architectural engineer and a partner of an architectural firm located in Jackson, Mississippi.FN2 He also is in the business of building homes. Extensive income generated by these businesses partially paid for petitioner's mud-racing and truck-pulling activities.

Mud racing is a relatively new entrant to the American sporting scene. It generally involves speed competition amongst four-wheel drive vehicles on a circular track which has been intentionally transformed into a mudhole. A mud-racing track is usually constructed as follows: a round asphalt speedway with a pond in its center is selected; a dirt track is constructed within the inner perimeter of the asphalt speedway; earthen berms are built along the inner and outer edges of the dirt track; and finally, large amounts of water are drained from the pond and pumped onto the dirt track in order to create water depths between one and three feet depending upon the location within the newly formed mudhole. Apparently, deeper water creates more exciting starts while smaller amounts of water produce a thicker and more viscid mud, which in turn, provides for slow-motion finishes.

Mud-racing drivers compete in four different classes: (1) vehicles with six-cylinder engines; (2) “V-8 stock,” i.e., eight-cylinder vehicles whose engines and remaining components are substantially unchanged from the factory; (3) “street-modified,” i.e., eight-cylinder vehicles whose engines are modified for racing but the remainder is substantially unchanged; and (4) “super-modified” which encompasses generally unrestricted multi-cylinder vehicles.

Truck pulling is an entirely different sporting event. Although it also includes similar classes of four-wheel drive vehicles which have been modified for pulling, the participants compete by attempting to tow a large weighted sled along a straight dirt runway. The sled normally contains 3,500 pounds of weights. At the beginning of each pulling attempt, the weights are positioned in the rear of the sled. As a competitor pulls the sled forward, the weights are mechanically shifted towards the front of the sled which increases the total pulling resistance. At some point, the resistance usually exceeds the vehicle's pulling power; hence, the sled does not advance any further. A competitor's success is determined by measuring the distance that the sled has been pulled: the further, the better.

As in mud racing, each truck-pulling participant competes in as many different classes as he has qualifying vehicles. Unlike mud racing, however, participation in a truck-pulling contest is by invitation only and there usually is no registration fee. Most truck-pulling events involve several days of competition. Cash awards are distributed to the winners and other high finishers at the end of each day of competition. Depending upon the size of the total purse, a truck-pulling competitor can win up to $1,000 per day in the “super-modified” class and possibly even $2,000 over a weekend.

Petitioner began to mud race in 1975 without ever having been a spectator at such an event. Petitioner competed in only one mud race during the 1975 season yet won $100 on his debut. During the 1976, 1977 and 1978 mud-racing seasons, petitioner entered 10, 20 and 26 races, respectively. Petitioner generally competed in the “super-modified” class while mud racing.

During 1977, petitioner became increasingly interested in truck pulling. He eventually converted a truck which had been substantially destroyed during a mud race into a

truck-pulling vehicle and began to compete in this sport. * * * Petitioner's interest in mud racing waned as his truck-pulling activities increased. This was largely the result of his realization that he had an increased likelihood of winning more money in truck pulling. Truck-pulling contests generally have larger purses and this sport is increasing in popularity. Many truck pulls draw over 15,000 paying spectators.

Petitioner drove all of the vehicles he entered in mud races and truck pulls. He never had any formal training for these activities; he acquired expertise through participation. Petitioner did not employ any crew or experienced personnel to assist him in either competition format. Petitioner performed most of the maintenance work on his vehicles although he did employ a machinist to assist him in preparing and repairing various engine components. His 11-year-old son occasionally assisted him. Petitioner devoted approximately 500 hours per year to his mud-racing and truck-pulling activities during the years in issue.

Petitioner enjoyed mud racing and truck pulling. When petitioner began to mud race, he anticipated that it would take him three years to recover his initial outlays. * * *

Section 183(a) provides that, except as otherwise permitted in that section, individual taxpayers will not be allowed deductions which are attributable to activities that are "not engaged in for profit." Section 183(b)(1) provides that deductions which would be allowable without regard to whether such activity is engaged in for profit shall be allowed. Section 183(b)(2) further provides that deductions which would be allowable only if such activity is engaged in for profit shall be allowed "but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1)."

The standard * * * is: did the individual engage in the activity "with the actual and honest objective of making a profit"? Although a taxpayer's expectation of profit need not be reasonable, the facts and circumstances must indicate that the taxpayer had the requisite profit objective. * * *

The question of whether petitioner's mud-racing and truck-pulling activities fall within the purview of section 183(a) is one of fact which must be resolved on the basis of all of the facts and circumstances and not just one factor.

Section 1.183–2(b), Income Tax Regs., lists some of the relevant factors, derived principally from caselaw, which "should normally be taken into account" in determining whether an activity is engaged in for profit. Benz v. Commissioner, supra at 383. The factors include: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

Upon examination of petitioner's mud-racing activities in light of the nine objective criteria set forth in the regulations, we hold that such endeavors constitute an activity "not engaged in for profit" within the scope of section 183(a). Although petitioner was experienced in mechanics and racing and had been "playing with automobiles" since he was 12, he had no prior experience in four-wheel drive vehicle competition prior to the start of his mud-racing activities. The racing of four-wheel drive vehicles through specially built mudholes also involves a great deal of recreational characteristics. Further, the profit potential from mud racing is generally low. Each participant must successfully complete numerous heats to even be eligible for the cash awards, thus significantly increasing the likelihood of elimination or damage to the mud racer. Finally, even assuming petitioner had won every mud race he entered (which is totally unsupported by petitioner's actual track record),

his total winnings would have been significantly less than his attendant expenses; therefore, petitioner did not have an actual and honest during the years in issue. Accordingly, all of petitioner's mud-racing expenses during the years in issue shall be governed by the provisions of section 183.

Upon review of petitioner's truck-pulling activities, however, we hold that such endeavors were engaged in for profit during petitioner's taxable year 1978.FN4 Petitioner carried on his truck-pulling activities in a workmanlike fashion, guided by the additional racing experience he gained during his mud-racing competition. Through his diligence and devotion of large amounts of time and effort, petitioner was ultimately ranked 35th in the nation by Truck-O-Rama, a national truck-pulling promoter. Petitioner also converted some of his mud-racing vehicles into truck-pulling devices, thus limiting his recreational use of such vehicles in future mud races, with no assurance that he would even be able to compete since participation in truck pulls is by invitation only. Finally, petitioner expanded into this new activity only after realizing that it had a greater profit potential than mud racing. Truck pulling differs from mud racing in several significant respects concerning its profitability potential. Truck-pulling contests generally have larger total purses and class prizes and this passtime is increasing in popularity. The truck-pulling circuit is also national in scope while mud racing is generally confined to the southeastern portions of the country. A truck-pulling participant's chances of elimination or damage to his vehicle is also significantly less than a mud racer's because a truck-pulling competitor's finish and eligibility for cash awards is determined by a single pulling attempt while mud racing involves numerous elimination heats.

While some of the objective criteria listed in the regulations weigh against the petitioner, we do not consider them significant enough to offset the criteria which weigh in his favor. Although petitioner did not maintain a formal set of records concerning his truck-pulling endeavors, he generally conducted this activity in a fashion similar to his construction business which was also engaged in for profit. * * * Further, the fact that petitioner's truck-pulling activities were not immediately profitable does not alter our opinion that petitioner had a bona fide objective of making a profit when he began to compete in truck-pulling contests. The regulations specifically acknowledge that losses can be incurred during the formative years of profit-oriented activities. * * * Finally, the fact that truck-pulling competition and the related preparatory activities involve some elements of recreation and pleasure for petitioner, who liked to work on cars, is not determinative.

United States v. Correll

389 U.S. 299 (1967)

Mr. Justice STEWART delivered the opinion of the Court.

The Commissioner of Internal Revenue has long maintained that a taxpayer traveling on business may deduct the cost of his meals only if his trip requires him to stop for sleep or rest. The question presented here is the validity of that rule.

The respondent in this case was a traveling salesman for a wholesale grocery company in Tennessee. He customarily left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner. In his income tax returns for 1960 and 1961, he deducted the cost of his morning and noon meals as 'traveling expenses' incurred in the pursuit of his business 'while away from home' under §162(a)(2) of the Internal Revenue Code of 1954. Because the respondent's daily trips required neither sleep nor rest, the Commissioner disallowed the deductions, ruling that the cost of the respondent's meals was a 'personal, living' expense under s 262[3] rather than a travel expense under s 162(a)(2). The respondent paid the tax, sued for a refund in the District Court, and there received a favorable jury verdict. The Court of Appeals for the Sixth Circuit affirmed, holding that the Commissioner's sleep or rest rule is not 'a valid regulation under the present statute.' 369 F.2d 87, 90. In order to resolve a conflict among the circuits on this recurring question of federal income tax administration,[5] we granted certiorari.

Under §162(a)(2), taxpayers 'traveling . . . away from home in the pursuit of a trade or business' may deduct the total amount 'expended for meals and lodging.'[6] As a result, even the taxpayer who incurs substantial hotel and restaurant expenses because of the special demands of business travel receives something of a windfall, for at least part of what he spends on meals represents a personal living expense that other taxpayers must bear without receiving any deduction at all. Not surprisingly, therefore, Congress did not extend the special benefits of §162(a)(2) to every conceivable situation involving business travel. It made the total cost of meals and lodging deductible only if incurred in the course of travel that takes the taxpayer 'away from home.' The problem before us involves the meaning of that limiting phrase.

[6] Prior to the enactment in 1921 of what is now s 162(a)(2), the Commissioner had promulgated a regulation allowing a deduction for the cost of meals and lodging away from home, but only to the extent that this cost exceeded 'any expenditures ordinarily required for such purposes when at home.' Treas.Reg. 45 (1920 ed.), Art. 292, 4 Cum.Bull. 209 (1921). Despite its logical appeal, the regulation proved so difficult to administer that the Treasury Department asked Congress to grant a deduction for the 'entire amount' of such meal and lodging expenditures. See Statement of Dr. T. S. Adams, Tax Adviser, Treasury Department, in Hearings on H.R. 8245 before the Senate Committee on Finance, 67th Cong., 1st Sess., at 50, 234—235 (1921). Accordingly, s 214(a)(1) of the Revenue Act of 1921, c. 136, 42 Stat. 239, for the first time included the language that later became s 162(a)(2). See n. 2, supra. The section was amended in a respect not here relevant by the Revenue Act of 1962, s 4(b), 76 Stat. 976.

In resolving that problem, the Commissioner has avoided the wasteful litigation and continuing uncertainty that would inevitably accompany any purely case-by-case approach to the question of whether a particular taxpayer was 'away from home' on a particular day. Rather than requiring 'every meal-purchasing taxpayer to take pot luck in the courts,' the Commissioner has consistently construed travel 'away from home' to exclude all trips requiring neither sleep nor rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed. By

so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who of course cannot deduct the cost of the meals they eat on the road. See Commissioner Internal Revenue v. Flowers, 326 U.S. 465, 66 S.Ct. 250, 90 L.Ed. 203.

Any rule in this area must make some rather arbitrary distinctions, but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury. And the Commissioner's rule surely makes more sense than one which would allow the respondent in this case to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office.

The Court of Appeals nonetheless found in the 'plain language of the statute' an insupperable obstacle to the Commissioner's construction. 369 F.2d 87, 89. We disagree. The language of the statute—'meals and lodging . . . away from home'—is obviously not self-defining. And to the extent that the words chosen by Congress cut in either direction, they tend to support rather than defeat the Commissioner's position, for the statute speaks of 'meals and lodging' as a unit, suggesting—at least arguably—that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well. Ordinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel, and Congress might well have thought that only taxpayer in that category should be permitted to deduct their living expenses while on the road. In any event, Congress certainly recognized, when it promulgated §162(a)(2), that the Commissioner had so understood its statutory predecessor. This case thus comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.'

Alternatives to the Commissioner's sleep or rest rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. §7805(a). In this area of limitless factual variations 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' Commissioner v. Stidger, 386 U.S. 287, 296, 87 S.Ct. 1065, 1071, 18 L.Ed.2d 53. The rule of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner. Because the rule challenged here has not been shown deficient on that score, the Court of Appeals should have sustained its validity. The judgment is therefore reversed.

Mr. Justice DOUGLAS, with whom Mr. Justice BLACK and Mr. Justice FORTAS, concur, dissenting.

The statutory words 'while away from home,' 26 U.S.C. §162(a)(2), may not in my view be shrunken to 'overnight' by administrative construction or regulations. 'Overnight' injects a time element in testing deductibility, while the statute speaks only in terms of geography. As stated by the Court of Appeals:

'In an era of supersonic travel, the time factor is hardly relevant to the question of whether or not travel and meal expenses are related to the taxpayer's business and cannot be the basis of a valid regulation under the present statute.' Correll v. United States, 369 F.2d 87, 89—90.

I would affirm the judgment below.

OTTAWA SILICA v. UNITED STATES

699 F.2d 1124 (Fed. Cir. 1983)

Before DAVIS, NICHOLS and NIES, Circuit Judges.

Ottawa was engaged in the mining, processing and marketing of industrial sand known as silica. Beginning in 1956, Ottawa acquired coast ranch properties in Oceanside, California. Oceanside, experienced rapid growth.* * * * This phenomenal population growth forced the city to expand geographically in the only direction it could, eastward, and generally towards plaintiff's mining operations. * * * * By the mid-1960's it became apparent that a new high school would be needed to accommodate the ever increasing high school population of Oceanside. The Oceanside-Carlsbad Union High School District asked Ottawa whether it would be interested in donating approximately 50 acres of its land for a school site. It was plain that if the school were built that this would hasten development of access roads that would benefit Ottawa. Ottawa donated a 49.37-acre site for the high school and another almost 20 acres of right-of-way for two access roads to the school. Ottawa claimed a charitable deduction of $319,523 for the value of the 49 acres transferred by the school district.

On its 1971 federal tax return, the Ottawa redetermined the fair market value of the high school site on the basis of a subsequent sale of an adjacent parcel to some land developers. Plaintiff claimed that the value of the land at the time of the initial sale had been actually $415,223 and therefore increased its carryover by $95,700. The Internal Revenue Service disallowed the deduction on the ground that it was not a charitable contribution within the meaning of 26 U.S.C. § 170 (1976).

The case law dealing with this aspect of a §170 deduction makes clear that a contribution made to a charity is not made for exclusively public purposes if the donor receives, or anticipates receiving a substantial benefit in return. * * * * In Singer, this court considered whether discount sales of sewing machines to schools and other charities entitled Singer to a charitable deduction. The court found that Singer, which at the time of the sales was in the business of selling sewing machines, had made the discount sales to the schools for the predominant purpose of encouraging the students to use and, in the future, to purchase its sewing machines, thereby increasing Singer's future sales. This purpose colored the discount sales, making them business transactions rather than charitable contributions. Accordingly, the court disallowed the deduction for the sales to the schools. The court allowed deductions for the discount sales made to other charities, however, because Singer had no expectation of increasing its sales by making the contributions and benefited only incidentally from them.

The Singer court noted that the receipt of benefits by the donor need not always preclude a charitable contribution. The court stated its reasoning as follows, at 106, 449 F.2d 413:

> [I]f the benefits received, or expected to be received, [by the donor] are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely incidental to the transfer), then in such case we feel that the transferor has received, or expects to receive, a quid pro quo sufficient to remove the transfer from the realm of deductibility under section 170.

Singer Co. v. United States, 196 Ct.Cl. at 106, 449 F.2d 423. The parties to the present case disagree as to the meaning of the above quotation. The plain language clearly indicates that a "substantial benefit" received in return for a contribution constitutes a quid pro quo, which precludes a deduction. The court defined a substantial benefit as one that is

"greater than those that inure to the general public from transfers for charitable purposes." Id. at 106, 449 F.2d at 423. Those benefits that inure to the general public from charitable contributions are incidental to the contribution, and the donor, as a member of the general public, may receive them. It is only when the donor receives or expects to receive additional substantial benefits that courts are likely to conclude that a quid pro quo for the transfer exists and that the donor is therefore not entitled to a charitable deduction. * * * *

Plaintiff argues that it received no benefits, except incidental ones as defined by Singer, in return for its contribution of the site, and it is therefore entitled to a § 170 deduction for the transfer of its land to the school district. After having considered the testimony and the evidence adduced at trial, I conclude that the benefits to be derived by plaintiff from the transfer were substantial enough to provide plaintiff with a quid pro quo for the transfer and thus effectively destroyed the charitable nature of the transfer.

To begin, although plaintiff is correct in arguing that it was not the moving party in this conveyance, and that the school district sought plaintiff out for a donation of a high school site, that alone fails to justify a § 170 deduction. The record clearly establishes that following the passage of a bonding referendum, which authorized the building of a new high school by the city of Oceanside in 1968, as many as nine sites had been evaluated. Because of the eastward growth of the city, Mr. LaFleur, the superintendent of the OCUHSD, felt that the ideal location for the new high school would be near El Camino Real. Following careful consideration, the city and school district decided that the best location for a high school would be on plaintiff's land. Thus, during the summer of 1968, John Steiger, the vice-mayor of Oceanside, and Mr. LaFleur approached Mr. Thomas Jones to see if plaintiff would consider making a site on the Freeman Ranch available for the new high school.

On September 20, 1968, Mr. LaFleur wrote to plaintiff's president, Mr. Thornton, to ask if plaintiff would be willing to donate 50 acres of its land for a school site. The record also establishes, however, that plaintiff was more than willing to oblige Mr. LaFleur on the basis of its own self-interest. Indeed, the evidence shows that on that same September 20, Mr. Jones also wrote to Mr. Thornton to advise him of the discussions he had participated in regarding a high school site. In his letter Mr. Jones stated that he had met with John Steiger and Larry Bagley, Oceanside's planning director, and had learned that the school district's first choice for a high school site was on land owned by plaintiff. In a most revealing statement, Mr. Jones went on to say:

> I was pessimistic when talking to John and Larry, but this actually could trigger and hasten the development of the whole eastern end of [the] Freeman and Jones *1133 [ranches] at no cost to us. The increase in these property values should be substantial if this should go through. In any event, nothing more is to be done on this until the school board writes to you and asks to open negotiations. On the other hand, I recommend that OR & DC actively pursue this, since a high school in this location would probably trigger the early development of El Camino Real from the May Co. to Mission Road.

The exact meaning of Mr. Jones' statement will be better understood following a full development of the prevailing circumstances at the time of the transfer. It should be recalled that plaintiff had amassed some 2,300 acres in eastern Oceanside, but only 481 acres had silica reserves. . . . . While a portion of the western boundary of the Freeman Ranch ran along El Camino Real, its northernmost boundary was about a mile from all of the major roads. The unavailability of major roads to service the northernmost reaches of the Cubbison and Freeman Ranches. * * * * The only thing frustrating the implementation of the plan was the inaccessibility of the Jones Ranch from Mission Boulevard. The following statement from the Pereira report shows that plaintiff was aware that the inaccessibility of the Jones Ranch to Mission Boulevard. * * * *

The construction of a high school on the Freeman Ranch, however, alleviated this problem for plaintiff. State and local officials required that the high school be serviced by two separate access roads. After some discussions, the school district and plaintiff agreed on the general direction of Mesa Drive which would provide the school with access to El Camino Real, and the surrounding topography dictated that the second road run north to Mission Boulevard through the Jones Ranch and parcels of property owned by Mr. Ivey and the Mission of San Luis Rey. This road, Rancho Del Oro Drive, provided plaintiff with access to the Jones Ranch directly from Mission Boulevard. Plaintiff could not have obtained such access to Mission Boulevard on its own unless both Mr. Ivey and the fathers at the mission had agreed to convey part of their land or easements to plaintiff. There is no evidence suggesting that either party was interested in doing so. Mr. Ivey, in fact, had resisted plaintiff's overtures about selling or developing his land. * * * *

It is thus quite apparent that plaintiff conveyed the land to the school district fully expecting that as a consequence of the construction of public access roads through its property it would receive substantial benefits in return. In fact, this is precisely what happened. Plaintiff obtained direct access to the Jones Ranch via Rancho Del Oro Drive and ultimately sold the ranch to a developer. Plaintiff also sold two parcels of the Freeman Ranch, lying north of Mesa Drive, to other developers. * * * * It is my opinion that the plaintiff knew that the construction of a school and the attendant roads on its property would substantially benefit the surrounding land, that it made the conveyance expecting its remaining property to increase in value, and that the expected receipt of these benefits at least partially prompted plaintiff to make the conveyance. Under Singer, this is more than adequate reason to deny plaintiff a charitable contribution for its conveyance.

CONCLUSION

It is concluded that plaintiff is not entitled to a charitable contribution pursuant to 26 U.S.C. § 170 (1976) for its conveyance of a school site to the Oceanside-Carlsbad Union High School District.

LOMBARDO v. COMMISSIONER

50 T.C.M. 1374 (1985)

RAUM, JUDGE.

[Taxpayer pleaded guilty to a state-law charge of felonious sale of marijuana. The police seized fourteen tons of marijuana, $148,000 of cash, and land where he was operating Under a plea bargain agreement, the taxpayer was placed on probation but was required under the plea bargain agreement to pay $145,000 to the country school fund.]

The only matter before us for decision is the deductibility of the charitable 'contributions' made by petitioner in fulfillment of an obligation under the Probation Judgment which specifically required 'compliance with the conditions of (petitioner's) plea bargain agreement.' * * * * [W]e think it clear that the . . . dominant objective of petitioner in accepting the plea bargain agreement was to avoid being sent to prison. His 'contributions' pursuant to the plea bargain agreement, as incorporated by the sentencing judge in the Probation Judgment, were nothing more than part of the consideration given by him to escape incarceration. We so find as a fact.

In the circumstances, petitioners' 'contributions' made under the compulsion of the plea bargains agreement, as incorporated in the Probation Judgment, could hardly qualify for deduction as 'charitable contributions' within section 170(c)(1), I.R.C. 1954. It has been firmly settled that '(i)f a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a 'gift' that may be classified as a charitable contribution. * * * * It would strain our credulity to the breaking point to conclude that petitioner's contributions proceeded even remotely from a charitable impulse. What we have here is a clear case of a 'gift' for a quid pro quo. In short, petitioner was faced with the unhappy choice: prison or 'gift'. He chose the latter. His 'gift' was merely a transfer in exchange for an expectation of freedom from prison. We need not belabor the point further. Petitioner made no charitable contribution that qualifies for deduction.3

The facts of this case suggest an intriguing question as to whether the trial court in the criminal case went beyond its powers in adopting a requirement in the plea bargain agreement that petitioner make a 'charitable' contribution of $145,000. It would appear that under North Carolina law, as alleged in the petition, the maximum fine that the court could impose was $5,000, see N.C. Gen. Stat. sec. 90-95(b)(2) (1981), and that there might therefore be some question (one that we have not explored) whether it could in effect exact further payment of $145,000 to an instrumentality or subdivision of the state. However, regardless of whether the trial court exceeded its power in this connection under North Carolina law, the blunt fact is that it did embody such an order in its Probation Judgment, and petitioners' compliance therewith certainly did not constitute a deductible charitable contribution within the meaning of section 170, I.R.C. 1954.

Decision will be entered for the respondent.

TAYLOR v. COMMISSIONER

54 T.C.M. 129 (1987)

SCOTT, JUDGE:

Due to a severe allergy, petitioner's doctor instructed him not to mow his lawn. Petitioner in 1982 paid a total of $178 to have his lawn mowed and claimed a medical expense deduction in that amount for lawn care.

OPINION

Petitioner contends that since his doctor had advised him not to mow his lawn, he is entitled to a deduction for amounts he paid someone else to do his lawn mowing. Respondent contends the amounts paid by petitioner for lawn mowing are nondeductible personal expenses under section 262 rather than section 213 medical expenses. * * * *

In this case, petitioner, bearing the burden of proof under Rule 142(a) must establish that the apparently personal expense of lawn care is a medical expense. Petitioner has cited no authority to support his position either in general or with respect to lawn care expenses specifically. Petitioner testified that due to a severe allergy his doctor had directed him not to perform lawn care activities but there was no showing why other family members could not undertake these activities or whether petitioner would have paid others to mow his lawn even absent his doctor's direction not to do so himself.

Doctor recommended activities have been held in a number of cases not to constitute deductible medical expenses where the expenses did not fall within the parameters of 'medical care.' For example in Altman v. Commissioner, 53 T.C. 487 (1969), this Court held that the expense of playing golf was not a deductible medical expense even though this activity was recommended by the taxpayer's doctor as treatment for his emphysema and provided therapeutic benefits. On this record we conclude that petitioner has not carried his burden of proof with respect to the deduction of lawn care costs as a medical expense and is thus not entitled to include the $178 expended for lawn care in his medical expense deductions.

Decision will be entered for the respondent.

Rev. Rul. 2012-25

2012-2 C.B.337

ISSUE

Whether an arrangement that recharacterizes taxable wages as nontaxable reimbursements or allowances satisfies the business connection requirement of the accountable plan rules under § 62(c) and the applicable regulations.

Situation 1.

Employer A, a company contracting with cable providers, employs technicians to install cable television systems at residential locations on behalf of different cable providers. Employee technicians are required to provide the tools and equipment necessary to complete the various installation jobs to which they are assigned.

Employer A compensates its employees on an hourly basis, which takes into account the fact that technicians are required to provide their own tools and equipment. Employer A decides to begin reimbursing its technicians for their tool and equipment expenses through a tool reimbursement arrangement (tool plan).

Under Employer A's tool plan, a technician provides Employer A with an amount equivalent to the technician's tool and equipment expenses incurred in connection with providing services to Employer A. Employer A takes the technician's total expenses for the year and divides the total amount by the number of hours a technician is expected to work over the course of a year to arrive at an hourly tool rate. Once Employer A has determined the hourly tool rate amount for a technician, it pays the technician a reduced hourly compensation rate and an hourly tool rate. Employer A treats the reduced hourly compensation as taxable wages. Employer A treats the hourly tool rate as a nontaxable reimbursement. The hourly tool rate plus the reduced hourly compensation rate approximately equal the pre-tool plan compensation rate. The tool plan tracks the hourly tool rate up to the amount of substantiated tool and equipment expenses. Once a technician has received tool plan payments for the total amount of his or her tool and equipment expenses, Employer A ceases paying the technician an hourly tool rate but increases the technician's hourly compensation to the pre-tool plan hourly compensation rate.

Situation 2.

Employer B, a staffing contractor, employs nurses and provides their services to hospitals throughout the country for short-term assignments. Employer B compensates all of the nurses on an hourly basis and the hourly compensation amount does not vary depending on whether the hospital is located away from the assigned nurse's tax home.

When Employer B sends nurses on assignment to hospitals that require them to travel away from their tax home and incur deductible expenses in connection with Employer B's business, Employer B treats a portion of the nurses' hourly compensation as a nontaxable *per diem* allowance for lodging, meals,

and incidental expenses under Employer B's *per diem* plan; Employer B treats the remaining portion of the nurses' hourly compensation as taxable wages. When Employer B sends the nurses on assignment to hospitals within commuting distance of their tax home, Employer B treats all of the nurses' compensation as taxable wages. In each case, the nurses receive the same total compensation per hour.

Situation 3.

Employer C, a construction firm, employs workers to build commercial buildings throughout a major metropolitan area. As part of their duties, some of Employer C's workers are required to travel between construction sites or otherwise use their personal vehicles for business purposes. These workers incur deductible business expenses in operating their personal vehicles in connection with their employment with Employer C. Employer C compensates all of its workers for their services on an hourly basis, which Employer C treats as taxable wages. Employer C also pays all of its workers, including those who are not required to travel or otherwise use their personal vehicles for Employer C's business, a flat amount per pay period that Employer C treats as a nontaxable mileage reimbursement.

Situation 4.

Employer D, a cleaning services company, employs cleaning professionals to perform house cleaning services for Employer D's clients. Employee cleaning professionals are required to provide the cleaning products and equipment necessary to complete the cleaning service jobs to which they are assigned.

Employer D compensates its employees on an hourly basis, which takes into account that employees are required to provide their own cleaning products and equipment. Employer D decides to begin reimbursing its employees for their cleaning and equipment expenses through a reimbursement arrangement.

Employer D prospectively alters its compensation structure by reducing the hourly compensation paid to all employees. Under Employer D's new reimbursement arrangement, employees can substantiate to Employer D the actual amount of deductible expenses incurred in purchasing their cleaning products and equipment in connection with performing services for Employer D. Employer D reimburses its employees for substantiated expenses incurred in performing services for Employer D. Any reimbursement paid under Employer D's reimbursement arrangement is paid in addition to the hourly compensation paid for the employees' services. Employees who do not incur expenses for cleaning products and equipment in connection with their jobs for Employer D, or who do not properly substantiate such expenses to Employer D, continue to receive the lower hourly compensation and do not receive any reimbursement and are not compensated in another way (for example, with a bonus) to substitute for the reduction in the hourly compensation. Employer D treats the hourly compensation as taxable wages. Employer D treats reimbursements for cleaning and equipment expenses as nontaxable reimbursements.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code (Code) defines gross income as all income from whatever source derived. Section 62(a) defines adjusted gross income as gross income minus certain deductions. Section 62(a)(2)(A) provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement. Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under section 1.62-2(c) of the Income Tax Regulations, if a reimbursement or other expense allowance arrangement meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses, all amounts paid under the arrangement are treated as paid under an accountable plan. Amounts treated as paid under an accountable plan are excluded from an employee's gross income, are exempt from withholding and payment of employment taxes, and are not reported as wages on the employee's Form W-2. If the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan, must be included in the employee's gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee's Form W-2.

Section 1.62-2(d)(1) provides that an arrangement satisfies the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions by part VI, subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. Thus, not only must an employee actually pay or incur a deductible business expense, but the expense must arise in connection with the employment for that employer.

Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if a payor pays an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses. Failure to meet this reimbursement requirement of business connection is referred to as wage recharacterization because the amount being paid is not an expense reimbursement but rather a substitute for an amount that would otherwise be paid as wages.

Section 1.62-2(j) *Example 1* provides an illustration of a case in which the reimbursement requirement is not satisfied. In this example, Employer S pays its engineers $200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer's travel expenses. On all other days, the engineer receives the full $200 as taxable wages. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, the $50 Employer S redesignates as travel expense reimbursement on days the engineer is away from home on business is not a reimbursement and the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather,

all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees' Forms W-2, and must withhold and pay employment taxes on the entire $200 when paid.

Section 1.62-2(j) *Example 3* also illustrates a failure to satisfy the reimbursement requirement. In this example, Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. The allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of the type described in § 1.62-2(d)(1) or (d)(2), the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the allowance Corporation R designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Corporation R must report all payments under the arrangement as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the payments when paid.

In Rev. Rul. 2004-1, 2004-1 C.B. 325, drivers of a courier company were paid a mileage allowance for local transportation expenses. In situation 1 of the ruling, the employer paid the couriers a commission equal to X percent of the per package charge (based on location, time of day, type of service, mileage between pickup and delivery, and other factors), known as the tag rate, and a mileage allowance equal to Y percent of the tag rate. In situation 2, the employer paid the couriers a commission equal to Z percent of the tag rate reduced by a mileage allowance equal to the number of miles traveled multiplied by the standard mileage rate. The revenue ruling concludes that the reimbursement arrangement in situation 1, which pays a mileage allowance as a fixed percentage of the tag rate, meets the business connection requirement. In contrast, the revenue ruling concludes that the reimbursement arrangement in situation 2, which subtracts a mileage allowance (calculated at the standard business mileage rate) from the driver's set commission rate and treats only the remaining commission as wages, fails the business connection requirement. The variable allocation between commission and mileage allowance in situation 2 ensures that each driver always receives the same gross amount regardless of the amount of deductible employee business expenses incurred by the courier by varying the amount treated as wages in light of the mileage allowance paid. Accordingly, the arrangement effectively recharacterizes amounts otherwise payable as a taxable commission as a non-taxable mileage allowance. The ruling provides that a *bona fide* reimbursement arrangement must preclude the recharacterization as a mileage allowance of amounts otherwise payable as commission. *See Shotgun Delivery v. United States*, 269 F.3d 969 (9th Cir. 2001) (holding that a plan guaranteeing that employee drivers always received 40% of the tag rate with a variable allocation between taxable wages and nontaxable mileage reimbursement was nonaccountable, and noting that "the evidence suggests that the plan's primary purpose was to treat the least amount possible of the driver's commission as taxable wages").

The legislative history of § 62(c) indicates that a taxpayer should not be able to recharacterize an amount that would have been paid as wages as a nontaxable reimbursement in order to avoid the two-percent of adjusted gross income limitation (two-percent floor), enacted by the Tax Reform Act of 1986, for deducting most employee business expenses. Specifically, the Tax Reform Act of 1986

significantly changed rules for deduction of employee business expenses by converting most of these expenses into itemized deductions that an employee could only deduct if the aggregate of such expenses exceeded the two-percent floor. However, the 1986 Act left in place the ability of a taxpayer to deduct from gross income and without regard to the two-percent floor, pursuant to § 62(a)(2)(A), employee business expenses incurred by a taxpayer as part of a reimbursement or other expense allowance arrangement with his or her employer. After enactment of the 1986 Act, tax practitioners proposed that employers could use reimbursement and expense allowance arrangements to (1) eliminate the effect of the two-percent floor on deductible employee expenses, and (2) save both employer and employee employment taxes by restructuring their compensation packages to convert a portion of an employee's compensation into a nontaxable reimbursement. This restructuring would permit employers to pay a lesser total amount while increasing employees' after-tax compensation.

Congress responded by enacting § 62(c) in § 702 of the Family Support Act of 1988,100 P.L. 485, 102 Stat. 2343(1988). In describing the conference agreement, the House-Senate Conference Committee Report on that Act states that "[i]f an above-the-line deduction is allowed for expenses incurred pursuant to a nonaccountable plan, the two-percent floor enacted in the [Tax Reform Act of 1986] could be circumvented solely by restructuring the form of the employee's compensation so that the salary amount is decreased, but the employee receives an equivalent nonaccountable expense allowance." H.R. Rep. No. 100-998, at 203, 100th Cong., 2nd Sess. (Sept. 28, 1988). Section 62(c) was enacted to prevent such restructuring of compensation arrangements and permit an above-the-line deduction only for expenses reimbursed under what legislative history referred to as an accountable plan.

Consistent with legislative history, the preamble to Treasury Decision 8324, 55 FR 51688, 1991-1 C.B. 20, 21 (1990), states:

> Some practitioners have asked whether a portion of an employee's salary may be recharacterized as being paid under a reimbursement arrangement. The final regulations clarify that if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other *bona fide* expenses related to the employer's business that are not deductible, the arrangement does not meet the business connection requirement of § 1.62-2(d) of the regulations and all amounts paid under the arrangement are treated as paid under a nonaccountable plan.... Thus, no part of an employee's salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.

While an employer may establish or modify its compensation structure to include nontaxable reimbursement under an accountable plan, recharacterizing as nontaxable reimbursements amounts that would otherwise be paid as wages violates the business connection requirement of § 1.62-2(d), and more specifically the reimbursement requirement of § 1.62-2(d)(3)(i). This is true even if an employee actually incurs a deductible expense in connection with employment with the employer.

The presence of wage recharacterization is based on the totality of facts and circumstances. Generally, wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred

deductible business expenses related to the employer's business. Wage recharacterization may occur in different situations. For example, an employer recharacterizes wages if it temporarily reduces taxable wages, substituting the reduction in wages with a payment that is treated as a nontaxable reimbursement and then, after total expenses have been reimbursed, increases taxable wages to the prior wage level. Similarly, an employer recharacterizes wages if it pays a higher amount as wages to an employee only when the employee does not receive an amount treated as nontaxable reimbursement and pays a lower amount as wages to an employee only when the employee also receives an amount treated as nontaxable reimbursement. An employer also recharacterizes wages if it routinely pays an amount treated as a nontaxable reimbursement to an employee who has not incurred *bona fide* business expenses.

HOLDINGS

Situation 1.

Employer A's tool plan does not satisfy the business connection requirement of the accountable plan rules because the employer pays the same gross amount to a technician regardless of whether the technician incurs (or is reasonably expected to incur) expenses related to Employer A's business. Specifically, Employer A's tool plan ensures that a technician receives approximately the same gross hourly amount by substituting a portion of what was paid as taxable wages with a tool rate amount that is treated as nontaxable reimbursement, and then increasing the wages again once all tool expenses have been reimbursed. Accordingly, the purported tool reimbursements are merely a recharacterization of wages because approximately the same amount is paid in all circumstances. The fact that a technician actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer A's tool plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 2.

Employer B's *per diem* plan does not satisfy the business connection requirement of the accountable plan rules because Employer B pays the same gross amount to nurses regardless of whether the nurses incur (or are reasonably expected to incur) travel expenses related to Employer B's business. Specifically, Employer B pays the same gross compensation to nurses, but a portion of the hourly compensation is treated as nontaxable *per diem* when a nurse is traveling away from his or her tax home on assignment. For nurses traveling away from their tax home on assignment, Employer B reduces the amount of the nurses' compensation treated as taxable wages and treats an amount equal to the reduction in compensation as a nontaxable *per diem*. For nurses assigned to hospitals within commuting distance of their tax homes, Employer B treats all compensation as taxable wages. Accordingly, the purported *per diem* payments are merely recharacterized wages because nurses receive the same gross compensation per hour regardless of whether travel expenses are incurred (or are reasonably expected to be incurred). The fact that a nurse traveling away from his or her tax home actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable

plan as set forth in § 1.62-2, Employer B's *per diem* plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 3.

Employer C's mileage reimbursement plan does not satisfy the business connection requirement of the accountable plan rules because it operates to routinely pay an amount as a mileage reimbursement to workers who have not incurred (and are not reasonably expected to incur) deductible business expenses in connection with Employer C's business. The purported mileage reimbursement is merely recharacterized wages because all workers receive an amount as a mileage reimbursement regardless of whether they incur (or are reasonably expected to incur) mileage expenses. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer C's mileage reimbursement plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 4.

Employer D's reimbursement arrangement satisfies the business connection requirement of the accountable plan rules. Employer D's plan only reimburses employees when a deductible business expense has been incurred in connection with performing services for Employer D and the reimbursement is not in lieu of wages that the employees would otherwise receive. Although Employer D has reduced the amount of compensation it pays all of its employees, the reduction in compensation is a substantive change in Employer D's compensation structure. Under Employer D's arrangement, reimbursement amounts are not guaranteed and employees who do not incur expenses in connection with Employer D's business, or who do not properly substantiate such expenses, continue to receive the reduced hourly compensation amount. These employees do not receive any reimbursement and are not compensated in another way to make up for the reduction in the hourly compensation. Employer D's reimbursement arrangement does not operate to pay the same or a substantially similar gross amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) expenses related to Employer D's business. The reimbursement is paid in addition to the employees' wages rather than as a substitute for wages that would otherwise be paid. Accordingly, Employer D's reimbursement arrangement satisfies the business connection requirement of § 1.62-2(d). Therefore, as long as the substantiation and return of excess amounts requirements are also met, Employer D's reimbursement arrangement is an accountable plan under § 62(c) and the applicable regulations.

Reg § 1.67-1T. 2-percent floor on miscellaneous itemized deductions (temporary).

(a)Type of expenses subject to the floor.

(1)In general. With respect to individuals, section 67 disallows deductions for miscellaneous itemized deductions (as defined in paragraph (b) of this section) in computing taxable income (i.e., so-called "below-the-line" deductions) to the extent that such otherwise allowable deductions do not exceed 2 percent of the individual's adjusted gross income (as defined in section 62 and the regulations thereunder). Examples of expenses that, if otherwise deductible, are subject to the 2-percent floor include but are not limited to-

(i) Unreimbursed employee expenses, such as expenses for transportation, travel fares and lodging while away from home, business meals and entertainment, continuing education courses, subscriptions to professional journals, union or professional dues, professional uniforms, job hunting, and the business use of the employee's home.

(ii) Expenses for the production or collection of income for which a deduction is otherwise allowable under section 212(1) and (2), such as investment advisory fees, subscriptions to investment advisory publications, certain attorneys' fees, and the cost of safe deposit boxes,

(iii) Expenses for the determination of any tax for which a deduction is otherwise allowable under section 212(3), such as tax counsel fees and appraisal fees, and

(iv) Expenses for an activity for which a deduction is otherwise allowable under section 183.

See section 62 with respect to deductions that are allowable in computing adjusted gross income (i.e., so-called "above-the-line" deductions).

(2)Other limitations. Except as otherwise provided in paragraph (d) of this section, to the extent that any limitation or restriction is placed on the amount of a miscellaneous itemized deduction, that limitation shall apply prior to the application of the 2-percent floor. For example, in the case of an expense for food or beverages, only 80 percent of which is allowable as a deduction because of the limitations provided in section 274(n), the otherwise deductible 80 percent of the expense is treated as a miscellaneous itemized deduction and is subject to the 2-percent limitation of section 67.

Baker v. Commissioner
T.C. Memo. 2006-60

CHIECHI, J.

Petitioner and Deanna Wus (Ms. Wus) have a daughter A and a son C (collectively, the children). At a time not disclosed by the record, Ms. Wus purchased a double-wide trailer (trailer) located at 153 Carnation Drive, Magnolia, Delaware. Ms. Wus, petitioner, and the children lived in the trailer for an undisclosed period of time prior to 2003. Sometime in 2002, Ms. Wus stopped residing in the trailer, but petitioner continued to live there until around mid-February 2003. Petitioner was unable to afford the payments for the mortgage loan, ground rent, and utilities with respect to the trailer after Ms. Wus stopped residing there.

Around mid-February 2003, petitioner moved to a duplex located at 299 Barney Jenkins Road, Felton, Delaware (Barney Jenkins Road property), that a friend of his owned. While residing at the Barney Jenkins Road property, petitioner paid his friend $300 a month and shared an undisclosed amount of utility expenses.

Sometime between the end of September or October 2003 and mid-November 2003, petitioner moved to a house located on 268 Fox Road, Dover, Delaware (Fox Road property), that his mother owned. While residing at the Fox Road property in 2003, petitioner paid his mother, who was living in Florida, $125 a week.

During 2003, petitioner, who worked as a plumber, and Ms. Wus were not married, lived in separate residences, and had no custody agreement concerning their daughter A who was four years old.

During 2003, Ms. Wus received public assistance for A's benefit from the State of Delaware, which listed Ms. Wus as the custodial parent of A. During that year, Medicaid, and not petitioner, provided healthcare benefits to A. During 2003, petitioner did not apply for food stamps or any other type of public assistance for his daughter A.

During 2003, petitioner and Ms. Wus each asked Rosemary Srase (Ms. Srase) to babysit the children at Ms. Srase's home. Ms. Srase was a longtime friend of petitioner and his mother who used to babysit petitioner when he was a child. Approximately two to three times a week during 2003, Ms. Srase usually babysat the children at her home for a few hours during the evenings. Occasionally during 2003, she babysat them during the daytime and overnight on weekends. During 2003, petitioner did not pay cash to Ms. Srase for babysitting the children for him. Instead, he did work for her at her home. Most of the time during 2003 that Ms. Srase babysat the children, she provided them with some food at her own expense. At no time during 2003 before petitioner moved to the Fox Road property did Ms. Srase babysit the children at petitioner's residence or personally observe them at petitioner's residence. When petitioner moved into the Fox Road property, Ms. Srase observed the children at that property.

On at least certain days during the period January 2 through March 31, 2003, the Dover Educational & Community Daycare Center (Daycare Center) provided daycare for the children. On most, but not all, of such days, Ms. Wus brought the children to, and petitioner picked them up from, the Daycare Center. On certain other days during the period January 2 through March 31, 2003, Ms. Wus brought the children to, and also picked them up from, the Daycare Center. On certain other days during that period, petitioner brought the children to, and also picked them up from, the Daycare Center. During the period January 2 through March 31, 2003, the times at which the children were brought to the Daycare Center ranged from as early as 6:45 a.m. to as late as 4:20 p.m., and the times at which the children were picked up from that center ranged from 11:00 a.m. to 5:45 p.m. In most instances, however, the children were brought to the Daycare Center before 9:00 a.m. and picked up from the Center between 4:30 p.m. and 5:30 p.m. During the period January 2 through March 31, 2003, both petitioner and Ms. Wus made

payments of undisclosed amounts toward the cost of the children's daycare at the Daycare Center.

**** In petitioner's 2003 return, petitioner claimed (1) a dependency exemption deduction for his daughter A, (2) head of household filing status, (3) the earned income tax credit, (4) the child tax credit, and (5) the additional child tax credit. In Ms. Wus's tax return for her taxable year 2003, Ms. Wus also claimed a dependency exemption deduction for her daughter A. ****

Section 151(a) permits a taxpayer to deduct an exemption amount for each dependent as defined in section 152. As pertinent here, section 152(a) defines the term "dependent" to include an individual who receives from the taxpayer over half of such individual's support for the calendar year in which the taxable year of the taxpayer begins and who is the taxpayer's daughter. Sec. 152(a)(1). As also pertinent here, if the taxpayer's daughter receives over half of her support during the calendar year from her parents who live apart at all times during the last six months of such year and if such daughter is in the custody of one or both of her parents for more than one-half of such year, the daughter will be treated for purposes of section 152(a) as having received over half of her support during the calendar year from the parent (custodial parent) having custody for the greater portion of the calendar year. Sec. 152(e)(1). Section 152(a) also defines the term "dependent" to include an individual who, for the taxable year of the taxpayer, has as such individual's principal place of abode the home of the taxpayer and is a member of the taxpayer's household and who received (or is treated as having received under, inter alia, section 152(e)) from the taxpayer over half of such individual's support for the calendar year in which the taxable year of the taxpayer begins. Sec. 152(a)(9).

In support of his position that he is entitled for his taxable year 2003 to a dependency exemption deduction for his daughter A, petitioner contends:

> Petitioner and two other witnesses testified that * * * [A] lived with her father, the petitioner from January 2003 until November 2003, when she went to live with her mother. They also testified that the mother took * * * [A] inconsistently on week-ends for those ten months. Further testimony provided that the petitioner maintained over half of the child's support for that period. * * * [Reproduced literally.]

With respect to whether petitioner is to be treated as the custodial parent under section 152(e)(1), the record establishes that petitioner and Ms. Wus had no custody agreement with respect to either of the children for 2003. However, the State of Delaware reported to respondent that Ms. Wus, and not petitioner, was the claimed child's custodial parent. Moreover, the record is devoid of evidence that we find to be reliable establishing that A lived with her father from January until November 2003 or that he otherwise had physical custody of A for a portion of 2003 that is greater than the portion of such year during which Ms. Wus had physical custody of A.

With respect to whether petitioner provided over one-half of A's support during 2003, petitioner must show the amount of total support incurred during that year on behalf of A from all sources, and he must establish that he provided over half of that amount. **** The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Sec. 1.152–1(a)(2)(i), Income Tax Regs. The total amount of support for each claimed dependent provided by all sources during the year in question must be shown by competent evidence. *Blanco v. Commissioner*, *supra* at 514. Where the amount of total support incurred on behalf of a child during such year is not shown, and may not reasonably be inferred from competent evidence, it is not possible to find that the taxpayer contributed more than one-half of such child's total support.

Petitioner failed to maintain any records establishing (1) the amount of total support incurred on behalf of A during 2003 and (2) the amount of such support that he provided to A during that year. During 2003, petitioner, who was a plumber, had total income and adjusted gross income of $15,349. Ms. Wus received public assistance from the State of Delaware for the

benefit of A. Moreover, A received healthcare benefits under Medicaid, and not from petitioner. Although for the period January 2 through March 31, 2003, both petitioner and Ms. Wus made payments toward the cost of providing A's daycare, the record is devoid of evidence establishing the total amount of such payments or the amount of such payments that petitioner made. In addition, Ms. Srase, who usually babysat A approximately two to three times a week during 2003, often provided food to A at Ms. Srase's own expense. Finally, as discussed above, although petitioner claims that A lived with him during all of 2003 except November and December of that year, his claim is not supported by evidence that we consider to be reliable.

On the record before us, we find that petitioner has failed to carry his burden of establishing that he is entitled for his taxable year 2003 to a dependency exemption deduction for his daughter A. ****

Claimed Earned Income Tax Credit

Section 32(a)(1) permits an eligible individual an earned income credit against such individual's tax liability. The earned income tax credit is calculated as a percentage of the individual's earned income. Sec. 32(a)(1). Section 32(a)(2) limits the credit allowed. Section 32(b) prescribes different percentages and amounts that are to be used to calculate the credit depending on whether the eligible individual has no qualifying children, one qualifying child, or two or more qualifying children.

As pertinent here, section 32(c)(1)(A)(i) defines the term "eligible individual" to mean "any individual who has a qualifying child for the taxable year". The term "qualifying child" with respect to any taxpayer for any taxable year includes a daughter of the taxpayer who has the "same principal place of abode as the taxpayer for more than one-half of such taxable year". Sec. 32(c)(3)(A)(i) and (ii) and (B)(i)(I).

It is petitioner's position that his daughter A is a qualifying child for purposes of the earned income tax credit because she had the same principal place of abode as petitioner for more than one-half of his taxable year 2003. We found above that petitioner failed to show that for his taxable year 2003 he maintained as his home a household that constituted the principal place of abode, as a member of such household, of his daughter A for more than one-half of that year. On the record before us, we find that petitioner has failed to carry his burden of showing that for his taxable year 2003 A is a qualifying child for purposes of the earned income tax credit.

On the record before us, we find that petitioner has failed to carry his burden of establishing that he is entitled for his taxable year 2003 to the earned income tax credit.

Arkansas Best Corporation v. Commissioner
485 U.S. 212 (1998)

Opinion. Justice MARSHALL delivered the opinion of the Court.

The issue presented in this case is whether capital stock held by petitioner Arkansas Best Corporation (Arkansas Best) is a "capital asset" as defined in § 1221 of the Internal Revenue Code regardless of whether the stock was purchased and held for a business purpose or for an investment purpose.

Arkansas Best is a diversified holding company. In 1968 it acquired approximately 65% of the stock of the National Bank of Commerce (Bank) in Dallas, Texas. Between 1969 and 1974, Arkansas Best more than tripled the number of shares it owned in the Bank, although its percentage interest in the Bank remained relatively stable. These acquisitions were prompted principally by the Bank's need for added capital. Until 1972, the Bank appeared to be prosperous and growing, and the added capital was necessary to accommodate this growth. As the Dallas real estate market declined, however, so too did the financial health of the Bank, which had a heavy concentration of loans in the local real estate industry. In 1972, federal examiners classified the Bank as a problem bank. The infusion of capital after 1972 was prompted by the loan portfolio problems of the bank.

Petitioner sold the bulk of its Bank stock on June 30, 1975, leaving it with only a 14.7% stake in the Bank. On its federal income tax return for 1975, petitioner claimed a deduction for an ordinary loss of $9,995,688 resulting from the sale of the stock. The Commissioner of Internal Revenue disallowed the deduction, finding that the loss from the sale of stock was a capital loss, rather than an ordinary loss, and that it therefore was subject to the capital loss limitations in the Internal Revenue Code. ****

Section 1221 of the Internal Revenue Code defines "capital asset" broadly as "property held by the taxpayer (whether or not connected with his trade or business)," and then excludes five specific classes of property from capital-asset status. In the statute's present form, the classes of property exempted from the broad definition are (1) "property of a kind which would properly be included in the inventory of the taxpayer"; (2) real property or other depreciable property used in the taxpayer's trade or business; (3) "a copyright, a literary, musical, or artistic composition," or similar property; (4) "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered" or from the sale of inventory; and (5) publications of the Federal Government. Arkansas Best acknowledges that the Bank stock falls within the literal definition of "capital asset" in § 1221, and is outside of the statutory exclusions. It asserts, however, that this determination does not end the inquiry. Petitioner argues that in *Corn Products Refining Co. v. Commissioner*, *supra*, this Court rejected a literal reading of § 1221, and concluded that assets acquired and sold for ordinary business purposes rather than for investment purposes should be given ordinary-asset treatment. Petitioner's reading of *Corn Products* finds much support in the academic literature and in the courts. Unfortunately for petitioner, this broad reading finds no support in the language of § 1221.

In essence, petitioner argues that "property held by the taxpayer (whether or not connected with his trade or business)" does not include property that is acquired and held for a business purpose. In petitioner's view an asset's status as "property" thus turns on the motivation behind its acquisition. This motive test, however, is not only nowhere mentioned in § 1221, but it is also in direct conflict with the parenthetical phrase "whether or not connected with his trade or business." The broad definition of the term "capital asset" explicitly makes irrelevant any consideration of the property's connection with the taxpayer's business, whereas petitioner's rule would make this factor

dispositive.[5]

[FN5] Petitioner mistakenly relies on cases in which this Court, in narrowly applying the general definition of "capital asset," has "construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income," even though these items are property in the broad sense of the word. United States v. Midland–Ross Corp., 381 U.S. 54, 57, 85 S.Ct. 1308, 1310, 14 L.Ed.2d 214 (1965). See, e.g., Commissioner v. Gillette Motor Co., 364 U.S. 130, 80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960) ("capital asset" does not include compensation awarded taxpayer that represented fair rental value of its facilities); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 243 (1958) ("capital asset" does not include proceeds from sale of oil payment rights); Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941) ("capital asset" does not include payment to lessor for cancellation of unexpired portion of a lease). This line of cases, based on the premise that § 1221 "property" does not include claims or rights to ordinary income, has no application in the present context. Petitioner sold capital stock, not a claim to ordinary income.

In a related argument, petitioner contends that the five exceptions listed in § 1221 for certain kinds of property are illustrative, rather than exhaustive, and that courts are therefore free to fashion additional exceptions in order to further the general purposes of the capital-asset provisions. The language of the statute refutes petitioner's construction. Section 1221 provides that "capital asset" means "property held by the taxpayer[,] ... but does not include" the five classes of property listed as exceptions. We believe this locution signifies that the listed exceptions are exclusive. The body of § 1221 establishes a general definition of the term "capital asset," and the phrase "does not include" takes out of that broad definition only the classes of property that are specifically mentioned. ****

In the end, petitioner places all reliance on its reading of *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29 (1955)—a reading we believe is too expansive. In *Corn Products*, the Court considered whether income arising from a taxpayer's dealings in corn futures was entitled to capital-gains treatment. The taxpayer was a company that converted corn into starches, sugars, and other products. After droughts in the 1930's caused sharp increases in corn prices, the company began a program of buying corn futures to assure itself an adequate supply of corn and protect against price increases. See *id.*, at 48, 76 S.Ct., at 22. The company "would take delivery on such contracts as it found necessary to its manufacturing operations and sell the remainder in early summer if no shortage was imminent. If shortages appeared, however, it sold futures only as it bought spot corn for grinding." *Id.*, at 48–49, 76 S.Ct., at 22–23. The Court characterized the company's dealing in corn futures as "hedging." *Id.*, at 51, 76 S.Ct., at 24. As explained by the Court of Appeals in *Corn Products*, "[h]edging is a method of dealing in commodity futures whereby a person or business protects itself against price fluctuations at the time of delivery of the product which it sells or buys." 215 F.2d 513, 515 (CA2 1954). In evaluating the company's claim that the sales of corn futures resulted in capital gains and losses, this Court stated:

> "Nor can we find support for petitioner's contention that hedging is not within the exclusions of [§ 1221]. Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of [§ 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. y(3)27 Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." 350 U.S., at 51–52, 76 S.Ct., at 23–24 (citations omitted).

The Court went on to note that hedging transactions consistently had been considered to give rise to ordinary gains and losses, and then concluded that the corn futures were subject to ordinary-asset treatment. *Id.*, at 52–53, 76 S.Ct., at 24–25.

The Court in *Corn Products* proffered the oft-quoted rule of construction that the definition of "capital asset" must be narrowly applied and its exclusions interpreted broadly, but it did not state explicitly whether the holding was based on a narrow reading of the phrase "property held by the taxpayer," or on a broad reading of the inventory exclusion of § 1221. In light of the stark language

of § 1221, however, we believe that *Corn Products* is properly interpreted as involving an application of § 1221's inventory exception. Such a reading is consistent both with the Court's reasoning in that case and with § 1221. The Court stated in *Corn Products* that the company's futures transactions were "an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing requirements." 350 U.S., at 50, 76 S.Ct., at 23. The company bought, sold, and took delivery under the futures contracts as required by the company's manufacturing needs. As Professor Bittker notes, under these circumstances, the futures can "easily be viewed as surrogates for the raw material itself." 2 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 51.10.3, p. 51–62 (1981). The Court of Appeals for the Second Circuit in *Corn Products* clearly took this approach. That court stated that when commodity futures are "utilized solely for the purpose of stabilizing inventory cost[,] ... [they] cannot reasonably be separated from the inventory items," and concluded that "property used in hedging transactions properly comes within the exclusions of [§ 1221]." 215 F.2d, at 516. This Court indicated its acceptance of the Second Circuit's reasoning when it began the central paragraph of its opinion: "Nor can we find support for petitioner's contention that hedging is not within the exclusions of [§ 1221]." 350 U.S., at 51, 76 S.Ct., at 24. In the following paragraph, the Court argued that the Treasury had consistently viewed such hedging transactions as a form of insurance to stabilize the cost of inventory, and cited a Treasury ruling which concluded that the value of a manufacturer's raw-material inventory should be adjusted to take into account hedging transactions in futures contracts. See *id.*, at 52–53, 76 S.Ct., at 24–25 (citing G.C.M. 17322, XV–2 Cum.Bull. 151 (1936)). This discussion, read in light of the Second Circuit's holding and the plain language of § 1221, convinces us that although the corn futures were not "actual inventory," their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of "property of a kind which would properly be included in the inventory of the taxpayer" in § 1221.

Petitioner argues that by focusing attention on whether the asset was acquired and sold as an integral part of the taxpayer's everyday business operations, the Court in *Corn Products* intended to create a general exemption from capital-asset status for assets acquired for business purposes. We believe petitioner misunderstands the relevance of the Court's inquiry. A business connection, although irrelevant to the initial determination whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory-purchase system, and instead amounted simply to speculation in corn futures, they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion. We conclude that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221.[7] Arkansas Best, which is not a dealer in securities, has never suggested that the Bank stock falls within the inventory exclusion. *Corn Products* thus has no application to this case.

It is also important to note that the business-motive test advocated by petitioner is subject to the same kind of abuse that the Court condemned in *Corn Products.* The Court explained in *Corn Products* that unless hedging transactions were subject to ordinary gain and loss treatment, taxpayers engaged in such transactions could "transmute ordinary income into capital gain at will." 350 U.S., at 53–54, 76 S.Ct., at 24–25. The hedger could garner capital-asset treatment by selling the future and purchasing the commodity on the spot market, or ordinary-asset treatment by taking delivery under the future contract. In a similar vein, if capital stock purchased and held for a business purpose is an ordinary asset, whereas the same stock purchased and held with an investment

motive is a capital asset, a taxpayer such as Arkansas Best could have significant influence over whether the asset would receive capital or ordinary treatment. Because stock is most naturally viewed as a capital asset, the Internal Revenue Service would be hard pressed to challenge a taxpayer's claim that stock was acquired as an investment, and that a gain arising from the sale of such stock was therefore a capital gain. Indeed, we are unaware of a single decision *****that has applied the business-motive test so as to require a taxpayer to report a gain from the sale of stock as an ordinary gain. If the same stock is sold at a loss, however, the taxpayer may be able to garner ordinary-loss treatment by emphasizing the business purpose behind the stock's acquisition. The potential for such abuse was evidenced in this case by the fact that as late as 1974, when Arkansas Best still hoped to sell the Bank stock at a profit, Arkansas Best apparently expected to report the gain as a capital gain. See 83 T.C., at 647–648.

We conclude that a taxpayer's motivation in purchasing an asset is irrelevant to the question whether the asset is "property held by a taxpayer (whether or not connected with his business)" and is thus within § 1221's general definition of "capital asset." Because the capital stock held by petitioner falls within the broad definition of the term "capital asset" in § 1221 and is outside the classes of property excluded from capital-asset status, the loss arising from the sale of the stock is a capital loss. *Corn Products Refining Co. v. Commissioner*, *supra*, which we interpret as involving a broad reading of the inventory exclusion of § 1221, has no application in the present context. Accordingly, the judgment of the Court of Appeals is affirmed.

Commissioner v. Gillette Motor Transport, Inc.

364 U.S. 130 (1960)

Mr. Justice HARLAN delivered the opinion of the Court.

The question in this case is whether a sum received by respondent from the United States as compensation for the temporary taking by the Government of its business facilities during World War II represented ordinary income or a capital gain. . . .

In 1944, respondent was a common carrier of commodities by motor vehicle. On August 4, 1944, respondent's drivers struck, and it completely ceased to operate. Shortly thereafter, because of the need for respondent's facilities in the transportation of war materiel, the President ordered the Director of the Office of Defense Transportation to 'take possession and assume control of' them. The Director assumed possession and control as of August 12, and appointed a Federal Manager, who ordered respondent to resume normal operations. The Federal Manager also announced his intention to leave title to the properties in respondent and to interfere as little as possible in the management of them. Subject to certain orders given by the Federal Manager from time to time, respondent resumed normal operations and continued so to function until the termination of all possession and control by the Government on June 16, 1945.

Pursuant to an Act of Congress creating a Motor Carrier Claims Commission, 62 Stat. 1222, 49 U.S.C.A. s 305 note, respondent presented its claim for just compensation. The Government contended that there had been no 'taking' of respondent's property but only a regulation of it. The Commission, however, determined that by assuming actual possession and control or respondent's facilities, the United States had deprived respondent of the valuable right to determine freely what use was to be made of them. In ascertaining the fair market value of that right, the Commission found that one use to which respondent's facilities could have been put was to rent them out, and that therefore their rental value represented a fair measure of respondent's pecuniary loss. The Commission noted that in other cases of temporary takings, it has typically been held that the market value of what is taken is the sum which would be arrived at by a willing lessor and a willing lessee. Accordingly, it awarded, and the respondent received in 1952, the sum of $122,926.21, representing the fair rental value of its facilities from August 12, 1944, until June 16, 1945, plus $34,917.78, representing interest on the former sum, or a total of $157,843.99.

The Commission of Internal Revenue asserted that the total compensation award represented ordinary income to respondent in 1952. Respondent contended that it constituted an amount received upon an 'involuntary conversion' of property used in its trade or business and was therefore taxable as long-term capital gain pursuant to s 117(j) of the Internal Revenue Code of 1939. . . .

Respondent stresses that the Motor Carrier Claims Commission, rejecting the Government's contention that only a regulation, rather than a taking, of its facilities had occurred, found that respondent had been deprived of property, and awarded compensation therefor. That is indeed true. But the fact that something taken by the Government is property compensable under the Fifth Amendment does not answer the entirely different question whether that thing comes within the capital-gains provisions of the Internal Revenue Code. Rather, it is necessary to determine the precise nature of the

property taken. Here the Commission determined that what respondent had been deprived of, and what the Government was obligated to pay for, was the right to determine freely what use to make of its transportation facilities. The measure of compensation adopted reflected the nature of that property right. Given these facts, we turn to the statute.

Section 117(j), under which respondent claims, is an integral part of the statute's comprehensive treatment of capital gains and losses. Long-established principles govern the application of the more favorable tax rates to long-term capital gains: (1) There must be first, a 'capital asset,' and second, a 'sale or exchange' of that asset (s 117(a)); (2) 'capital asset' is defined as 'property held by the taxpayer,' with certain exceptions not here relevant (s 117(a)(1)); and (3) for purposes of calculating gain, the cost or other basis of the property (s 113(b), 26 U.S.C.A. s 113(b)) must be subtracted from the amount realized on the sale or exchange (s 111(a), 26 U.S.C.A. s 111(a)).

Section 117(j), added by the Revenue Act of 1942, effects no change in the nature of a capital asset. It accomplishes only two main objectives. First, it extends capital-gains treatment to real and depreciable personal property used in the trade or business, the type of property involved in this case. Second, it accords such treatment to involuntary conversions of both capital assets, strictly defined, and property used in the trade or business. Since the net effect of the first change is merely to remove one of the exclusions made to the definition of capital assets in s 117(a)(1), it seems evident that 'property used in the trade or business,' to be eligible for capital-gains treatment, must satisfy the same general criteria as govern the definition of capital assets. The second change was apparently required by the fact that this Court had given a narrow construction to the term 'sale or exchange.' See Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 61 S.Ct. 878, 85 L.Ed. 1310. But that change similarly had no effect on the basic notion of what constitutes a capital asset.

While a capital asset is defined in s 117(a)(1) as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199. Thus the Court has held that an unexpired lease, Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168, corn futures, Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29 and oil payment rights, Commissioner of Internal Revenue v. P. G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743, are not capital assets even though they are concededly 'property' interests in the ordinary sense. And see Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv.L.Rev. 985, 987—989 and Note 7.

In the present case, respondent's right to use its transportation facilities was held to be a valuable property right compensable under the requirements of the Fifth Amendment. However, that right was not a capital asset within the meaning of ss 117(a)(1) and 117(j). To be sure, respondent's facilities were themselves property embraceable as capital assets under s 117(j). Had the Government taken a fee in those facilities, or damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion

of capital assets. See, e.g., Waggoner, 15 T.C. 496; Henshaw, 23 T.C. 176. But here the Government took only the right to determine the use to which those facilities were to be put.

That right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves. Respondent suggests no method by which a cost basis could be assigned to the right; yet it is necessary, in determining the amount of gain realized for purposes of s 117, to deduct the basis of the property sold, exchanged, or involuntarily converted from the amount received. s 111(a). Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions. See cases cited, 364 U.S. at page 134, 80 S.Ct. at page 1500. In short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent. That is precisely the situation here, and the fact that the transaction was involuntary on respondent's part does not change the nature of the case.

Respondent lays stress on the use of the terms 'seizure' and 'requisition' in s 117(j). More specifically, the section refers to the 'involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets * * *.' (Emphasis added.) It is contended that the Government's action in the present case is perhaps the most typical example of a seizure or requisition, and that, therefore, Congress must have intended to treat it as a capital transaction. This argument, however, overlooks the fact that the seizure or requisition must be 'of property used in the trade or business (or) capital assets.' We have already shown that s 117(j) does not change the long-standing meaning of these terms and that the property taken by the Government in the present case does not come within them. The words 'seizure' and 'requisition' are not thereby deprived of effect, since they equally cover instances in which the Government takes a fee or damages or otherwise impairs the value of physical property.

We conclude that the amount paid to respondent as the fair rental value of its facilities from August 12, 1944, to June 16, 1945, represented ordinary income to it. A fortiori, the interest on that sum is ordinary income. Kieselbach v. Commissioner, 317 U.S. 399, 63 S.Ct. 303, 87 L.Ed. 358.

Reversed.

Mr. Justice DOUGLAS dissents.

Bell's Estate v. Commissioner
137 F.2d 454 (8th Cir. 1943)

SANBORN, Circuit Judge.

The question for decision is whether, under the Revenue Act of 1936, the consideration received by the life beneficiary of a trust for the transfer of the life interest to the remainderman was ordinary income or was capital. ****

The Commissioner contends that the consideration received by the life beneficiaries for their respective life interests was in reality an advance payment of future income of the trusts during their life expectancies, and was taxable as ordinary income *****. This contention is based mainly upon the opinion of the Supreme Court in Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168, in which it was held that the amount received by a lessor from a lessee as consideration for the cancellation of a lease was, in effect, a substitute for the future rents reserved in the lease, and was therefore income and not a return of capital. **** [Ed. Note: The Board of Tax Appeals held for the government based on Hort].

If the case of Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465, is still the law, the decision of the Board will, in our opinion, have to be reversed. **** There can be no question that in Blair v. Commissioner, supra, the Supreme Court ruled that assignments of life interests such as those here involved are transfers of interests in the trust assets, and are not merely assignments of income. **** The Supreme Court has not, expressly or by implication, overruled or modified its decision in Blair v. Commissioner, supra. The assignments in Helvering v. Horst, supra, Helvering v. Eubank, supra, and Harrison v. Schaffner, supra, are distinguishable from the assignments involved in Blair v. Commissioner, supra, and from the assignments involved in the instant cases. The Supreme Court has made the distinction, and it is not for this Court to unmake it. ****

The decision of the Board is reversed, and the cases are remanded for further proceedings not inconsistent herewith.

Commissioner v. Clay B. Brown

380 U.S. 563 (1965)

Mr. Justice Goldberg, Mr. Chief Justice Warren and Mr. Justice Black dissented.

Mr. Justice WHITE delivered the opinion of the Court.

. . . Clay Brown, members of his family and three other persons owned substantially all of the stock in Clay Brown & Company, with sawmills and lumber interests near Fortuna, California. Clay Brown, the president of the company and spokesman for the group, was approached by a representative of California Institute for Cancer Research in 1952, and after considerable negotiation the stockholders agreed to sell their stock to the Institute for $1,300,000, payable $5,000 down from the assets of the company and the balance within 10 years from the earnings of the company's assets. It was provided that simultaneously with the transfer of the stock, the Institute would liquidate the company and lease its assets for five years to a new corporation, Fortuna Sawmills, Inc., formed and wholly owned by the attorneys for the sellers.[4] Fortuna would pay to the Institute 80% of its operating profit without allowance for depreciation or taxes, and 90% of such payments would be paid over by the Institute to the selling stockholders to apply on the $1,300,000 note. This note was noninterest bearing, the Institute had no obligation to pay it except from the rental income and it was secured by mortgages and assignments of the assets transferred or leased to Fortuna. If the payments on the note failed to total $250,000 over any two consecutive years, the sellers could declare the entire balance of the note due and payable. The sellers were neither stockholders nor directors of Fortuna but it was provided that Clay Brown was to have a management contract with Fortuna at an annual salary and the right to name any successor manager if he himself resigned.[5]

[4] The net current assets subject to liabilities were sold by the Institute to Fortuna for a promissory note which was assigned to sellers. The lease covered the remaining assets of Clay Brown & Company. Fortuna was capitalized at $25,000, its capital being paid in by its stockholders from their own funds.

[5] Clay Brown's personal liability for some of the indebtedness of Clay Brown & Company, assumed by Fortuna, was continued. He also personally guaranteed some additional indebtedness incurred by Fortuna.

The transaction was closed on February 4, 1953. Fortuna immediately took over operations of the business under its lease, on the same premises and with practically the same personnel which had been employed by Clay Brown & Company. Effective October 31, 1954, Clay Brown resigned as general manager of Fortuna and waived his right to name his successor. In 1957, because of a rapidly declining lumber market, Fortuna suffered severe reverses and its operations were terminated. Respondent sellers did not repossess the properties under their mortgages but agreed they should be sold by the Institute with the latter retaining 10% of the proceeds. Accordingly, the property was sold by the Institute for $300,000. The payments on the note from rentals and from the sale of the properties totaled $936,131.85. Respondents returned the payments received from rentals as the gain from the sale of capital assets. The Commissioner, however, asserted the payments were taxable as ordinary income and were not capital gain within the meaning of I.R.C.1939, s 117(a)(4) and I.R.C.1954, s 1222(3). These sections provide that '(t)he term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months . . . .'

In the Tax Court, the Commissioner asserted that the transaction was a sham and that in any event respondents retained such an economic interest in and control over the property sold that the transaction could not be treated as a sale resulting in a long-term capital gain. A divided Tax Court, 37 T.C. 461, found that there had been

considerable goodfaith bargaining at arm's length between the Brown family and the Institute, that the price agreed upon was within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of its assets, that the primary motivation for the Institute was the prospect of ending up with the assets of the business free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property and the money for use in cancer research, and that there had been a real change of economic benefit in the transaction.[6] Its conclusion was that the transfer of respondents' stock in Clay Brown & Company to the Institute was a bona fide sale arrived at in an arm's-length transaction and that the amounts received by respondents were proceeds from the sale of stock and entitled to long-term capital gains treatment under the Internal Revenue Code. The Court of Appeals affirmed, 9 Cir., 325 F.2d 313, and we granted certiorari, 377 U.S. 962, 84 S.Ct. 1647, 12 L.Ed.2d 734.

Having abandoned in the Court of Appeals the argument that this transaction was a sham, the Commissioner now admits that there was real substance in what occurred between the Institute and the Brown family. The transaction was a sale under local law. The Institute acquired title to the stock of Clay Brown & Company and, by liquidation, to all of the assets of that company, in return for its promise to pay over money from the operating profits of the company. If the stipulated price was paid, the Brown family would forever lose all rights to the income and properties of the company. Prior to the transfer, these respondents had access to all of the income of the company; after the transfer, 28% of the income remained with Fortuna and the Institute. Respondents had no interest in the Institute nor were they stockholders or directors of the operating company. Any rights to control the management were limited to the management contract between Clay Brown and Fortuna, which was relinquished in 1954.

Whatever substance the transaction might have had, however, the Commissioner claims that it did not have the substance of a sale within the meaning of s 1222(3). His argument is that since the Institute invested nothing, assumed no independent liability for the purchase price and promised only to pay over a percentage of the earnings of the company, the entire risk of the transaction remained on the sellers. Apparently, to qualify as a sale, a transfer of property for money or the promise of money must be to a financially responsible buyer who undertakes to pay the purchase price other than from the earnings or the assets themselves or there must be a substantial down payment which shifts at least part of the risk to the buyer and furnishes some cushion against loss to the seller.

To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term 'sale,' is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it.

'Capital gain' and 'capital asset' are creatures of the tax law and the Court has been inclined to give these terms a narrow, rather than a broad, construction. Corn Products Co. v. Commissioner, 350 U.S. 46, 52, 76 S.Ct. 20, 24, 100 L.Ed. 29. A 'sale,' however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. 'Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words 'sale' and 'exchange' are not to be read any differently.' Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249, 61 S.Ct.

878, 880, 85 L.Ed. 1310; Hanover Bank v. Commissioner, 369 U.S. 672, 687, 82 S.Ct. 1080, 1088, 8 L.Ed.2d 187; Commissioner v. Korell, 339 U.S. 619, 627—628, 70 S.Ct. 905, 909—910, 94 L.Ed. 1108; Crane v. Commissioner, 331 U.S. 1, 6, 67 S.Ct. 1047, 1050, 91 L.Ed. 1301; Lang v. Commissioner, 289 U.S. 109, 111, 53 S.Ct. 534, 535, 77 L.Ed. 1066; Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560, 52 S.Ct. 211, 213, 76 L.Ed. 484.

'A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent,' State of Iowa v. McFarland, 110 U.S. 471, 478, 4 S.Ct. 210, 214, 28 L.Ed. 198; it is a contract 'to pass rights of property for money,—which the buyer pays or promises to pay to the seller . . . ,' Williamson v. Berry, 8 How. 495, 544, 12 L.Ed. 1170. Compare the definition of 'sale' in s 1(2) of the Uniform Sales Act and in s 2—106(1) of the Uniform Commercial Code. The transaction which occurred in this case was obviously a transfer of property for a fixed price payable in money.

Unquestionably the courts, in interpreting a statute, have some 'scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results . . . or would thwart the obvious purpose of the statute.' Helvering v. Hammel, 311 U.S. 504, 510—511, 61 S.Ct. 368, 371, 85 L.Ed. 303; cf. Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134, 80 S.Ct. 1497, 1500, 4 L.Ed. 1617; and Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694, 2 L.Ed.2d 743. But it is otherwise 'where no such consequences (would) follow and where * * * it appears to be consonant with the purposes of the Act . . . .' Helvering v. Hammel, supra, 311 U.S. at 511, 61 S.Ct. at 371; Takao Ozawa v. United States, 260 U.S. 178, 194, 43 S.Ct. 65, 67, 67 L.Ed. 199. We find nothing in this case indicating that the Tax Court or the Court of Appeals construed the term 'sale' too broadly or in a manner contrary to the purpose or policy of capital gains provisions of the Code.

Congress intended to afford capital gains treatment only in situations 'typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.' Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134, 80 S.Ct. 1497, 1500. It was to 'relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments' that capital gains were taxed differently by Congress. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199; Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694, 2 L.Ed.2d 743.

As of January 31, 1953, the adjusted net worth of Clay Brown & Company as revealed by its books was $619,457.63. This figure included accumulated earnings of $448,471.63, paid in surplus, capital stock and notes payable to the Brown family. The appraised value as of that date, however, relied upon by the Institute and the sellers, was.$1,064,877, without figuring interest on deferred balances. Under a deferred payment plan with a 6% interest figure, the sale value was placed at $1,301,989. The Tax Court found the sale price agreed upon was arrived at in an arm's-length transaction, was the result of real negotiating and was 'within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.' 37 T.C. 461, 486.

Obviously, on these facts, there had been an appreciation in value accruing over a period of years, Commissioner v. Gillette Motor Transport, Inc., supra, and an 'increase in the value of the income-producing property.' Commissioner v. P. G. Lake, Inc., supra, at 266, 78 S.Ct. at 695. This increase taxpayers were entitled to realize at capital gains rates on a cash sale of their stock; and likewise if they sold on a deferred payment plan taking an installement note and a mortgage as security. Further, if the down payment was less than 30% (the 1954 Code requires no down payment at all) and the transaction otherwise satisfied I.R.C.1939, s 44,

the gain itself could be reported on the installment basis.

In the actual transaction, the stock was transferred for a price payable on the installment basis but payable from the earnings of the company. Eventually $936,131.85 was realized by respondents. This transaction, we think, is a sale, and so treating it is wholly consistent with the purposes of the Code to allow capital gains treatment for realization upon the enhanced value of a capital asset.

The Commissioner, however, embellishes his risk-shifting argument. Purporting to probe the economic realities of the transaction, he reasons that if the seller continues to bear all the risk and the buyer none, the seller must be collecting a price for his risk-bearing in the form of an interest in future earnings over and above what would be a fair market value of the property. Since the seller bears the risk, the so-called purchase price must be excessive and must be simply a device to collect future earnings at capital gains rates.

We would hesitate to discount unduly the power of pure reason and the argument is not without force. But it does present difficulties. In the first place, it denies what the tax court expressly found—that the price paid was within reasonable limits based on the earnings and net worth of the company; and there is evidence in the record to support this finding. We do not have, therefore, a case where the price has been found excessive.

Secondly, if an excessive price is such an inevitable result of the lack of risk-shifting, it would seem that it would not be an impossible task for the Commissioner to demonstrate the fact. However, in this case he offered no evidence whatsoever to this effect; and in a good many other cases involving similar transactions, in some of which the reasonableness of the price paid by a charity was actually contested, the Tax Court has found the sale price to be within reasonable limits, as it did in this case.[7]

Thirdly, the Commissioner ignores as well the fact that if the rents payable by Fortuna were deductible by it and not taxable to the Institute, the Institute could pay off the purchase price at a considerably faster rate than the ordinary corporate buyer subject to income taxes, a matter of considerable importance to a seller who wants the balance of his purchase price paid as rapidly as he can get it. The fact is that by April 30, 1955, a little over two years after closing this transaction, $412,595.77 had been paid on the note and within another year the sellers had collected another $238,498.80, for a total of $651,094.57.

Furthermore, risk-shifting of the kind insisted on by the Commissioner has not heretofore been considered an essential ingredient of a sale for tax purposes. In LeTulle v. Scofield, 308 U.S. 415, 60 S.Ct. 313, 84 L.Ed. 355, one corporation transferred properties to another for cash and bonds secured by the properties transferred. The Court held that there was ‘a sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange,’ id., at 421, 60 S.Ct. at 316, since the seller retained only a creditor’s interest rather than a proprietary one. ‘(T)hat the bonds were secured solely by the assets transferred and that upon default, the bonholder would retake only the property sold, (did not change) his status from that of a creditor to one having a proprietary stake.’ Ibid. Compare Marr v. United States, 268 U.S. 536, 45 S.Ct. 575, 69 L.Ed. 1079. To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale. The term ‘sale’ is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrence of a ‘sale.’ To accept the Commissioner’s definition of sale would have wide ramifications which we are not prepared to visit upon taxpayers, absent

congressional guidance in this direction.

The Commissioner relies heavily upon the cases involving a transfer of mineral interests, the transferor receiving a bonus and retaining a royalty or other interest in the mineral production. Burnet v. Harmel, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199; Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489; Thomas v. Perkins, 301 U.S. 655, 57 S.Ct. 911, 81 L.Ed. 1324; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 66 S.Ct. 409, 90 L.Ed. 343; Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 66 S.Ct. 861, 90 L.Ed. 1062; Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S.Ct. 395, 100 L.Ed. 347. Thomas v. Perkins is deemed particularly pertinent. There a leasehold interest was transferred for a sum certain payable in oil as produced and it was held that the amounts paid to the transferor were not includable in the income of the transferee but were income of the transferor. We do not, however, deem either Thomas v. Perkins or the other cases controlling.

First, 'Congress . . . has recognized the peculiar character of the business of extracting natural resources,' Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 33, 66 S.Ct. 861, 866; see Stratton's Independence Ltd. v. Howbert, 231 U.S. 399, 413—414, 34 S.Ct. 136, 138—139, 58 L.Ed. 285, which is viewed as an income-producing operation and not as a conversion of capital investment, Anderson v. Helvering, 310 U.S. 404, at 407, 60 S.Ct. 952, at 953, 84 L.Ed. 1277, but one which has its own built-in method of allowing through depletion 'a tax-free return of the capital consumed in the production of gross income through severance,' Anderson v. Helvering, supra, at 408, 60 S.Ct. at 954, which is independent of cost and depends solely on production, Burton-Sutton, 328 U.S. at 34, 66 S.Ct. at 866. Percentage depletion allows an arbitrary deduction to compensate for exhaustion of the asset, regardless of cost incurred or any investment which the taxpayer may have made. The Commissioner, however, would assess to respondents as ordinary income the entire amount of all rental payments made by the Institute, regardless of the accumulated values in the corporation which the payments reflected and without regard for the present policy of the tax law to allow the taxpayer to realize on appreciated values at the capital gains rates.

Second, Thomas v. Perkins does not have unlimited sweep. The Court in Anderson v. Helvering, supra, pointed out that it was still possible for the owner of a working interest to divest himself finally and completely of his mineral interest by effecting a sale. In that case the owner of royalty interest, fee interest and deferred oil payments contracted to convey them for $160,000 payable $50,000 down and the balance from one-half the proceeds which might be derived from the oil and gas produced and from the sale of the fee title to any of the lands conveyed. The Court refused to extend Thomas v. Perkins beyond the oil payment transaction involved in that case. Since the transferor in Anderson had provided for payment of the purchase price from the sale of fee interest as well as from the production of oil and gas, 'the reservation of this additional type of security for the deferred payments serve(d) to distinguish this case from Thomas v. Perkins. It is similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall at all events equal the specified sum.' Anderson v. Helvering, supra, 310 U.S. at 412—413, 60 S.Ct. at 956. Hence, there was held to be an outright sale of the properties, all of the oil income therefrom being taxable to the transferee notwithstanding the fact of payment of part of it to the seller. The respondents in this case, of course, not only had rights against income, but if the income failed to amount to $250,000 in any two consecutive years, the entire amount could be declared due, which was secured by a lien on the real and personal properties of the company.

There is another reason for us not to disturb the ruling of the Tax Court and the Court of Appeals. In 1963, the Treasury Department, in the course

of hearings before the Congress, noted the availability of capital gains treatment on the sale of capital assets even though the seller retained an interest in the income produced by the assets. The Department proposed a change in the law which would have taxed as ordinary income the payments on the sale of a capital asset which were deferred over more than five years and were contingent on future income. Payments, though contingent on income, required to be made within five years would not have lost capital gains status nor would payments not contingent on income even though accompanied by payments which were. Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. I (rev.), on the President's 1963 Tax Message, pp. 154—156.

Congress did not adopt the suggested change but it is significant for our purposes that the proposed amendment did not deny the fact or occurrence of a sale but would have taxed as ordinary income those income-contingent payments deferred for more than five years. If a purchaser could pay the purchase price out of a earnings within five years the seller would have capital gain rather than ordinary income. The approach was consistent with allowing appreciated values to be treated as capital gain but with appropriate safeguards against reserving additional rights to future income. In comparison, the Commissioner's position here is a clear case of 'overkill' if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises. There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation. And if the Commissioner's approach is intended as a limitation upon the tax treatment of sales generally, it represents a considerable invasion of current capital gains policy, a matter which we think is the business of Congress, not ours.

The problems involved in the purchase of a going business by a taxexempt organization have been considered and dealt with by the Congress. Likewise, it was given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.' American Automobile Ass'n v. United States, 367 U.S. 687, 697, 81 S.Ct. 1727, 1732, 6 L.Ed.2d 1109.

Affirmed.

Mr. Justice HARLAN, concurring.

Were it not for the tax laws, the respondents' transaction with the Institute would make no sense, except as one arising from a charitable impulse. However the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. The Code gives the Institute a tax exemption which makes it capable of taking a greater after-tax return from a business than could a non-tax-exempt individual or corporation. Respondents traded a residual interest in their business for a faster payout apparently made possible by the Institute's exemption. The respondents gave something up; they received something substantially different in return. If words are to have meaning, there was a 'sale or exchange.'

Obviously the Institute traded on its tax exemption. The Government would deny that there was an exchange, essentially on the theory that the Institute did not put anything at risk; since its exemption is unlimited, like the magic purse that always contains another penny, the

Institute gave up nothing by trading on it.

One may observe preliminarily that the Government's remedy for the so-called 'bootstrap' sale—defining sale or exchange so as to require the shifting of some business risks—would accomplish little by way of closing off such sales in the future. It would be neither difficult nor burdensome for future users of the bootstrap technique to arrange for some shift of risks. If such sales are considered a serious abuse, ineffective judicial correctives will only postpone the day when Congress is moved to deal with the problem comprehensively. Furthermore, one may ask why, if the Government does not like the tax consequences of such sales, the proper course is not to attack the exemption rather than to deny the existence of a 'real' sale or exchange.

The force underlying the Government's position is that the respondents did clearly retain some risk-bearing interest in the business. Instead of leaping from this premise to the conclusion that there was no sale or exchange, the Government might more profitably have broken the transaction into components and attempted to distinguish between the interest which respondents retained and the interest which they exchanged. The worth of a business depends upon its ability to produce income over time. What respondents gave up was not the entire business, but only their interest in the business' ability to produce income in excess of that which was necessary to pay them off under the terms of the transaction. The value of such a residual interest is a function of the risk element of the business and the amount of income it is capable of producing per year, and will necessarily be substantially less than the value of the total business. Had the Government argued that it was that interest which respondents exchanged, and only to that extent should they have received capital gains treatment, we would perhaps have had a different case.

I mean neither to accept nor reject this approach, or any other which falls short of the all-or-nothing theory specifically argued by the petitioner, specifically opposed by the respondents, and accepted by the Court as the premise for its decision. On a highly complex issue with as wide ramifications as the one before us, it is vitally important to have had the illumination provided by briefing and argument directly on point before any particular path is irrevocably taken. Where the definition of 'sale or exchange' is concerned, the Court can afford to proceed slowly and by stages. The illumination which has been provided in the present case convinces me that the position taken by the Government is unsound and does not warrant reversal of the judgment below. Therefore I concur in the judgment to affirm.

Mr. Justice GOLDBERG, with whom THE CHIEF JUSTICE and Mr. Justice BLACK join, dissenting.

The essential facts of this case which are undisputed illuminate the basic nature of the transaction at issue. Respondents conveyed their stock in Clay Brown & Co., a corporation owned almost entirely by Clay Brown and the members of his immediate family, to the California Institute for Cancer Research, a tax-exempt foundation. The Institute liquidated the corporation and transferred its assets under a five-year lease to a new corporation, Fortuna, which was managed by respondent Clay Brown, and the shares of which were in the name of Clay Brown's attorneys, who also served as Fortuna's directors. The business thus continued under a new name with no essential change in control of its operations. Fortuna agreed to pay 80% of its pretax profits to the Institute as rent under the lease, and the Institute agreed to pay 90% of this amount to respondents in payment for their shares until the respondents received $1,300,000, at which time their interest would terminate and the Institute would own the complete beneficial interest as well as all legal interest in the

business. If remittances to respondents were less than $250,000 in any two consecutive years or any other provision in the agreements was violated, they could recover the property. The Institute had no personal liability. In essence respondents conveyed their interest in the business to the Institute in return for 72% of the profits of the business and the right to recover the business assets if payments fell behind schedule.

At first glance it might appear odd that the sellers would enter into this transaction, for prior to the sale they had a right to 100% of the corporation's income, but after the sale they had a right to only 72% of that income and would lose the business after 10 years to boot. This transaction, however, afforded the sellers several advantages. The principal advantage sought by the sellers was capital gain, rather than ordinary income, treatment for that share of the business profits which they received. Further, because of the Tax Code's charitable exemption and the lease arrangement with Fortuna,[2] the Institute believed that neither it nor Fortuna would have to pay income tax on the earnings of the business. Thus the sellers would receive free of corporate taxation, and subject only to personal taxation at capital gains rates, 72% of the business earnings until they were paid $1,300,000. Without the sale they would receive only 48% of the business earnings, the rest going to the Government in corporate taxes, and this 48% would be subject to personal taxation at ordinary rates. In effect the Institute sold the respondents the use of its tax exemption, enabling the respondents to collect $1,300,000 from the business more quickly than they otherwise could and to pay taxes on this amount at capital gains rates. In return, the Institute received a nominal amount of the profits while the $1,300,000 was being paid, and it was to receive the whole business after this debt had been paid off. In any realistic sense the Government's grant of a tax exemption was used by the Institute as part of an arrangement that allowed it to buy a business that in fact cost it nothing. I cannot believe that Congress intended such a result.

The Court today legitimates this bootstrap transaction and permits respondents the tax advantage which the parties sought. The fact that respondent Brown, as a result of the Court's holding, escapes payment of about $60,000 in taxes may not seem intrinsically important—although every failure to pay the proper amount of taxes under a progressive income tax system impairs the integrity of that system. But this case in fact has very broad implications. We are told by the parties and by interested amici that this is a test case. The outcome of this case will determine whether this bootstrap scheme for the conversion of ordinary income into capital gain, which has already been employed on a number of occasions, will become even more widespread.[3] It is quite clear that the Court's decision approving this tax device will give additional momentum to its speedy proliferation. In my view Congress did not sanction the use of this scheme under the present revenue laws to obtain the tax advantages which the Court authorizes. Moreover, I believe that the Court's holding not only deviates from the intent of Congress but also departs from this Court's prior decisions.

The purpose of the capital gains provisions of the Internal Revenue Code of 1954, s 1201 et seq., is to prevent gains which accrue over a long period of time from being taxed in the year of their realization through a sale at high rates resulting from their inclusion in the higher tax brackets. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199. These provisions are not designed, however, to allow capital gains treatment for the recurrent receipt of commercial or business income. In light of these purposes this Court has held that a 'sale' for capital gains purposes is not produced by the mere transfer of legal title. Burnet v. Harmel, supra; Palmer v. Bender,

287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489. Rather, at the very least, there must be a meaningful economic transfer in addition to a change in legal title. See Corliss v. Bowers, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916. Thus the question posed here is not whether this transaction constitutes a sale within the terms of the Uniform Commercial Code or the Uniform Sales Act—we may assume it does—but, rather, the question is whether, at the time legal title was transferred, there was also an economic transfer sufficient to convert ordinary income into capital gain by treating this transaction as a 'sale' within the terms of I.R.C. s 1222(3). . . . .

To hold as the Court does that this transaction constitutes a 'sale' within the terms of I.R.C. s 1222(3), thereby giving rise to capital gain for the income received, legitimates considerable tax evasion. Even if the Court restricts its holding, allowing only those transactions to be s 1222(3) sales in which the price is not excessive, its decision allows considerable latitude for the unwarranted conversion of ordinary income into capital gain. Valuation of a closed corporation is notoriously difficult. The Tax Court in the present case did not determine that the price for which the corporation was sold represented its true value; it simply stated that the price 'was the result of real negotiating' and 'within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.' 37 T.C., at 486. The Tax Court, however, also said that '(i)t may be . . . that petitioner (Clay Brown) would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization.' 37 T.C., at 485. Indeed, this latter supposition is highly likely, for the Institute was selling its tax exemption, and this is not the sort of asset which is limited in quantity. Though the Institute might have negotiated in order to receive beneficial ownership of the corporation as soon as possible, the Institute, at no cost to itself, could increase the price to produce an offer too attractive for the seller to decline. Thus it is natural to anticipate sales such as this taking place at prices on the upper boundary of what courts will hold to be a reasonable price—at prices which will often be considerably greater than what the owners of a closed corporation could have received in a sale to buyers who were not selling their tax exemptions. Unless Congress repairs the damage done by the Court's holding, I should think that charities will soon own a considerable number of closed corporations, the owners of which will see no good reason to continue paying taxes at ordinary income rates. It should not be necessary, however, for Congress to address itself to this loophole, for I believe that under the rpesent laws it is clear that Congress did not intend to accord capital gains treatment to the proceeds of the type of sale present here.

Although the Court implies that it will hold to be 'sales' only those transactions in which the price is reasonable, I do not believe that the logic of the Court's opinion will justify so restricting its holding. If this transaction is a sale under the Internal Revenue Code, entitling its proceeds to capital gains treatment because it was arrived at after hard negotiating, title in a conveyancing sense passed, and the beneficial ownership was expected to pass at a later date, then the question recurs, which the Court does not answer, why a similar transaction would cease to be a sale if hard negotiating produced a purchase price much greater than actual value. The Court relies upon Kolkey v. Commissioner, 254 F.2d 51 (C.A.7th Cir.), as authority holding that a bootstrap transaction will be struck down where the price is excessive. In Kolkey, however, the price to be paid was so much greater than the worth of the corporation in terms of its anticipated income that it was highly unlikely that the price would in fact ever be paid; consequently it was improbable that the sellers' interest in the business would ever be extinguished. Therefore, in Kolkey the

court, viewing the case as one involving 'thin capitalization,' treated the notes held by the sellers as equity in the new corporation and payments on them as dividends. Those who fashion 'bootstrap' purchases have become considerably more sophisticated since Kolkey; vastly excessive prices are unlikely to be found and transactions are fashioned so that the 'thin capitalization' argument is conceptually inapplicable. Thus I do not see what rationale the Court might use to strike down price transactions which, though excessive, do not reach Kolkey's dimensions, when it upholds the one here under consideration. Such transactions would have the same degree of risk-shifting, there would be no less a transfer of ownership, and consideration supplied by the buyer need be no less than here.

Further, a bootstrap tax avoidance scheme can easily be structured under which the holder of any income-earning asset 'sells' his asset to a tax-exempt buyer for a promise to pay him the income produced for a period of years. The buyer in such a transaction would do nothing whatsoever; the seller would be delighted to lose his asset at the end of, say, 30 years in return for capital gains treatment of all income earned during that period. It is difficult to see, on the Court's rationale, why such a scheme is not a sale. And, if I am wrong in my reading of the Court's opinion, and if the Court would strike down such a scheme on the ground that there is no economic shifting of risk or control, it is difficult to see why the Court upholds the sale presently before it in which control does not change and any shifting of risk is nominal.

I believe that the Court's overly conceptual approach has led to a holding which will produce serious erosion of our progressive taxing system, resulting in greater tax burdens upon all taxpayers. The tax avoidance routes opened by the Court's opinion will surely be used to advantage by the owners of closed corporations and other income-producing assets in order to evade ordinary income taxes and pay at capital gains rates, with a resultant large-scale ownership of private businesses by tax-exempt organizations.[5] While the Court justifies its result in the name of conceptual purity,[6] it simultaneously violates long-standing congressional tax policies that capital gains treatment is to be given to significant economic transfers of investment-type assets but not to ordinary commercial or business income and that transactions are to be judged on their entire substance rather than their naked form. Though turning tax consequences on form alone might produce greater certainty of the tax results of any transaction, this stability exacts as its price the certainty that tax evasion will be produced. In Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694, 2 L.Ed.2d 743, this Court recognized that the purpose of the capital gains provisions of the Internal Revenue Code is "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' . . . And this exception has always been narrowly construed so as to protect the revenue against artful devices.' I would hold in keeping with this purpose and in order to prevent serious erosion of the ordinary income tax provisions of the Code, that the bootstrap transaction revealed by the facts here considered is not a 'sale' within the meaning of the capital gains provisions of the Code, but that it obviously is an 'artful device,' which this Court ought not to legitimate. The Court justifies the untoward result of this case as permitted tax avoidance; I believe it to be a plain and simple case of unwarranted tax evasion.

Freda v. Commissioner
656 F.3d 570 (7th Cir. 2011)

TINDER, Circuit Judge.

****

C & F is an Illinois-based meat processing company. In the early 1980s, C & F developed a process for making and freezing pre-cooked sausage that had the appearance and taste of home-cooked sausage. C & F applied for and obtained a patent protecting its new process. C & F treated as trade secrets all subsequent refinements to the process; we use the term "C & F process" to refer to the process and related trade secrets.

In 1985, one of C & F's long-time customers, Pizza Hut, expressed an interest in using sausage made pursuant to the C & F process in its outlets nationwide, which would result in purchases of at least 200,000 pounds per week. The catch was that C & F had to agree to share the C & F process with Pizza Hut's other sausage suppliers so that Pizza Hut could offer its customers a uniform product. Later that year, Pizza Hut and C & F signed an agreement pursuant to which C & F disclosed to Pizza Hut information relating to the C & F process, and Pizza Hut promised to keep mum about those details. C & F also entered into separate confidential licensing agreements with several of Pizza Hut's other suppliers, disclosing its C & F process in exchange for promises of confidentiality and licensing fees.

Pizza Hut faltered on its end of the bargain: it failed to buy sufficient quantities of sausage from C & F and allegedly—it has never admitted wrongdoing—divulged crucial information regarding the C & F process to IBP, Inc., another meat processing company with whom C & F had not signed a confidentiality or licensing agreement. IBP replicated the C & F process, set its prices below C & F's, and began selling large quantities of sausage to Pizza Hut. Pizza Hut bought less and less sausage from C & F, and C & F suffered financially. C & F eventually filed suit against both Pizza Hut and IBP in the Northern District of Illinois in 1993. In its second amended complaint, C & F alleged, *inter alia,* that Pizza Hut "misappropriated [its] trade secrets by, among other things: (a) acquiring the trade secrets through fraudulent misrepresentations and omissions, and (b) disclosing and using such trade secrets, after notice, without express or implied consent of C & F." "As a result," the complaint continued, "C & F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses, and expenditures." ****

Pizza Hut and C & F settled the trade secret misappropriation claim for $15.3 million in January 2002. The settlement agreement provided for "a lump-sum payment in full and complete discharge and settlement of the Lawsuit and all other past, present, and future claims that could be asserted now or in the future by the C & F Parties and Pizza Hut related to the events or circumstances described in the Lawsuit." After deducting attorneys' fees, expenses, and a sizeable payment to a former shareholder (who redeemed his shares to C & F in exchange for an interest in the suit) from the settlement, C & F walked away with $6.12 million. ****[T]he sole issue remaining for the tax court was whether the $6.12 million should have been reported as ordinary income or long-term capital gain. ****

The shareholders first "ask this Court to adopt a rule that, as a matter of law, settlement proceeds received as a result of a sole claim for misappropriation of a capital asset are taxed as capital gains." Because C & F's claim had at its center a capital asset, they contend, all compensation C & F (and they) received in settlement of that claim must also be treated as capital in nature.

This broad-brush approach obscures some crucial finer points of the so-called "origin of the claim" doctrine, the underlying principles of which are applicable here. (It also elevates form over substance, which is generally frowned upon in tax jurisprudence, *see, e.g., Frank Lyon,* 435 U.S. at 583–84, 98 S.Ct. 1291, and potentially opens the door to exploitation of the beneficial—and exceptional—capital gains tax rate, *cf. Womack v. Comm'r,* 510 F.3d 1295, 1299 (11th Cir.2007) ("Congress intended ordinary income to be the default tax rate, with capital gains treatment

an exception only in appropriate cases.").) The origin of the claim doctrine had its roots in a dispute over legal expenses a taxpayer incurred while defending his income-producing property during a divorce dispute. *See United States v. Gilmore,* 372 U.S. 39, 83 S.Ct. 623, 9 L.Ed.2d 570 (1963); *Reynolds,* 296 F.3d at 614. **** While the doctrine in its purest form is not directly applicable here, the principles underlying it long have been. *See, e.g., Canal–Randolph Corp. v. United States,* 568 F.2d 28, 33 (7th Cir.1977) (per curiam). That is, "the [tax] classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as having the same nature as the right compromised." *Nahey v. Comm'r,* 196 F.3d 866, 868 (7th Cir.1999) (quoting *Alexander v. Internal Revenue Serv.,* 72 F.3d 938, 942 (1st Cir.1995)). To determine the "nature" of the "right compromised," the shareholders invite us to look no further than the title of their claim: trade secret misappropriation.

Perhaps in a different case that quick glance could resolve the matter. But trade secret misappropriation, aside from signaling that a capital asset may be in some way implicated, does not tell us very much about the actual nature of C & F's original claim, which can take many forms. ****

Here, the tax court, after reviewing the record and hearing testimony on the matter at trial, found that "Pizza Hut paid the amount at issue to C & F for 'lost profits, lost opportunities, operating losses and expenditures.' " This finding of fact, *see Alexander,* 72 F.3d at 944, which tracks the language of the relief requested in C & F's complaint and has some support in the trial testimony, is not clearly erroneous, particularly when it is viewed, as it must be, in the light most favorable to the finding, **** We agree that a finding that C & F sought only lost profits, or was compensated only for lost profits in the settlement, would be "an incorrect way of reading the complaint." *Id.* at 579. But the way we see it, the tax court did not err when it concluded that the shareholders "failed to carry their burden that [the settlement payment] did not represent damages for lost profits *or other items taxed as ordinary income.*" *Freda v. Comm'r,* T.C.M. (CCH) 2009–191 (emphasis added). (The tax court also noted that, even assuming C & F had fulfilled that burden, it had not met its other burden of establishing what portion of the payment at issue should be treated as long-term capital gain for the tax year in question.)

**** The shareholders did not offer the tax court evidence which undercut the Commissioner's reasonable conclusion that the damages C & F alleged were the main attraction rather than mere placeholders; their sole attempt to do so was (properly) rejected on hearsay grounds. They likewise failed to make any effort to explain why they voluntarily treated some of the money they received for a virtually identical claim (trade secret misappropriation against IBP) as ordinary income if all such claims necessarily net capital gains. Based on the record before it, the tax court did not err in upholding the Commissioner's presumptively correct determination that the settlement was not "in lieu of" a replacement of capital. *Cf. Sager Glove,* 311 F.2d at 212 (similar finding in context of antitrust suit).

We are similarly unmoved by the shareholders' alternative argument, that the alleged misappropriation and subsequent settlement payment in fact constituted a protracted commercial transaction in which a capital asset held for more than a year was exchanged for money. In their view, Pizza Hut "bought" a capital asset when it misappropriated the C & F process, then completed the sale or exchange years later by "paying" C & F with the settlement. *See Lehman v. Comm'r,* 835 F.2d 431, 435 (2d Cir.1987) (noting that the fact that taxpayer did not receive compensation for alleged sale for more than 16 years did not "militate[ ] against finding that the payment was within [26 U.S.C.] § 1235").

This argument grows out of 26 U.S.C. § 1222(3), which defines as "long-term capital gain" proceeds from the "sale or exchange of a capital asset held for more than 1 year," and 26 U.S.C. § 1235, which provides that "[a] transfer ... of property consisting of all substantial rights to a patent ... shall be considered the sale or exchange of a capital asset held for more than 1 year." ****

The facts of the case undermine their position, however. The tax court found that Pizza Hut disclosed the C & F process to IBP in 1989. Four years later, C & F filed suit against both Pizza Hut and IBP. It secured a sizeable jury verdict against IBP for trade secret misappropriation. **** C & F necessarily retained a rather valuable right associated with its trade secret (at least until technological advances

rendered the once-groundbreaking C & F process obsolete), one that was not transferred to Pizza Hut at any point during the 13 years separating the misappropriation from the settlement payment. C & F could not have transferred all substantial rights in its trade secret while simultaneously keeping a $10.9 million right to exclude IBP in its back pocket. "[A] seller that transfers less than all substantial rights to a trade secret generally is not eligible for capital gain treatment." ****

Moreover, the settlement agreement gives no indication that Pizza Hut believed it was compensating C & F for the sale or even the use of its trade secrets. *See Lehman*, 835 F.2d at 435. It states only that $15.3 million was tendered "in consideration of the dismissal with prejudice of the lawsuit," not in exchange for anything else Pizza Hut previously or concurrently received. Transactions involving the transfer of capital assets must be "in the nature of a sale" to qualify for capital gains treatment. **** Here, the tax court expressly concluded that "Pizza Hut did not pay the amount at issue under the settlement agreement for C & F's sale or exchange of the C & F trade secret to Pizza Hut." Without at least some hallmarks of a sale, C & F's transfer to Pizza Hut of its trade secrets should not be considered one for tax purposes.

The tax court rightly concluded that the settlement payment did not represent the final phase of a 13–year–long transfer of a capital asset. Because there was not a complete transfer of all substantial rights, there was no "sale" of a capital asset or long-term capital gain resulting therefrom.

MERCHANTS NATIONAL BANK v. COMMISSIONER

199 F.2d 657 (5th Cir. 1952)

STRUM, Circuit Judge.

On January 1, 1941, the petitioner held notes of Alabama Naval Stores Company, representing loans made by the bank to the Naval Stores Company, on which there was an unpaid balance of $49,025.00. In 1941 and 1943, at the direction of national bank examiners, the bank charged these notes off as worthless, thereafter holding them on a 'zero' basis. Deductions for the charge-offs, as ordinary losses, were allowed in full by the Commissioner on petitioner's income tax returns in 1941 and 1943. In 1944, petitioner sold the notes to a third party for $18,460.58, which it reported on its return for 1944 as a long term capital gain and paid its tax on that basis. The Commissioner held this sum to be ordinary income, taxable at a higher rate than long term capital gains, and entered a deficiency assessment accordingly, in which he was sustained by the Tax Court. This is the basis of the 1944 controversy.

The rule is well settled, and this Court has held, that when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year.

When these notes were charged off as a bad debt in the first instance, the bank deducted the amount thereof from its ordinary income, thus escaping taxation on that portion of its income in those years. The amount subsequently recovered on the notes restores pro tanto the amount originally deducted from ordinary income, and is accordingly taxable as ordinary income, not as a capital gain. When the notes were charged off, and the bank recouped itself for the capital loss by deducting the amount thereof from its current income, the notes were no longer capital assets for income tax purposes. To permit the bank to reduce its ordinary income by the amount of the loss in the first instance, thus gaining a maximum tax advantage on that basis, and then permit it to treat the amount later recovered on the notes as a capital gain, taxable on a much lower basis than ordinary income, would afford the bank a tax advantage on the transaction not contemplated by the income tax laws.

The fact that the bank sold these notes to a third party, instead of collecting the amount in question from the maker of the notes does not avoid the effect of the rule above stated. * * * *

As the recoveries in question were ordinary income, not capital gains, the 1944 deficiency was properly entered.

Affirmed.

Alderson v. Commissioner

317 F.2d 790 (9th Cir. 1963)

Before BARNES and MERRILL, Circuit Judges, and CRARY, District Judge.

CRARY, District Judge.

The question presented is whether the transactions whereby taxpayers transferred one parcel of realty and acquired another constituted a sale, the gain from which is recognizable under [Section 1001(c)].

On May 21, 1957, following negotiations between petitioners and Alloy Die Casting Company, hereinafter referred to as Alloy, representatives of petitioners and Alloy executed escrow instructions to the Orange County Title Company, hereinafter referred to as Orange, constituting a purchase and sale agreement whereby petitioners agreed to sell their Buena Park property, consisting of 31.148 acres or agricultural property, to Alloy for $5,550.00 per acre, a total price of $172,871.40. Pursuant to the terms of said agreement, Alloy deposited $17,205.00 in the Orange escrow toward purchase of the Buena Park property.

Some time after the execution of the May 21st escrow petitioners located 115.32 acres of farming land in Monterey County, California, hereinafter referred to as the Salinas property, which they desired to obtain in exchange for their Buena Park property.

On August 19, 1957, petitioners and Alloy executed an amendment to their May 21, 1957, escrow providing that 'the Salinas property be acquired by Alloy and exchanged for the Buena Park property in lieu of the original contemplated cash transaction.' (R. 21). The amendment further provides that if the exchange was not effected by September 11, 1957, the original escrow re the purchase for cash would be carried out. On the same day (August 19th) petitioners' daughter, Jean Marie Howard, acting for petitioners, executed escrow instructions to the Salinas Title Guarantee Company, hereinafter referred to as Salinas Title, in the form of 'Buyer's Instructions.' The parties have agreed that the acts of petitioners' daughter, Jean Marie Howard, with respect to the transactions here involved, are to be considered as acts of the petitioners, and any acts of said daughter are hereinafter referred to as acts of petitioners. The escrow instructions last mentioned provided for payment of $190,000.00 for the Salinas property, that title was to be taken in the name of Salinas Title, that $19,000.00 had been deposited with Orange and that the remaining $171,000.00 would also be deposited with Orange. The instructions also stated that Salinas Title was authorized to deed the Salinas property to Alloy, provided Salinas Title could 'immediately record a deed from Alloy . . . to James Alderson and Clarissa E. Alderson, his wife, issuing final title evidence in the last mentioned grantees.' (R. 21-22, R.Br. 5).

On August 20, 1957, petitioners authorized Orange to pay $19,000.00 into the Salinas escrow, which was done, and directed Orange to pay $171,000.00 into the Salinas escrow when these funds became available. (R. 22).

On August 22, 1957, Alloy, by letter to petitioners, summarized the agreements of the parties re the manner of accomplishing the transfer of the properties between them. (R.Br. 6). The letter further stated that Alloy's representative would deposit $172,871.40 (the cash amount for the Buena Park property as per May 21st escrow) with Salinas Title on assurance that the agreements would be effected. The letter was countersigned by petitioners.

By deed dated August 20, 1957, title to the

Salinas property was transferred to Salinas Title. By deed dated August 21, 1957, Salinas Title conveyed the Salinas property to Alloy. By deed dated August 26, 1957, petitioners conveyed the Buena Park property to Alloy and deed dated August 29, 1957, conveyed the Salinas property from Alloy to petitioners. All four of these deeds were recorded September 4, 1957. (R.Br. 6).

On September 3, 1957, Alloy, acting through its attorney, Elliott H. Pentz, deposited $172,871.40, belonging to Alloy, into the Salinas escrow, on Alloy's behalf, with instruction that said sum should be used to complete the purchase of the Salinas property. (R. 17, 24, 72-73). The said $172,871.40, plus the $19,000.00 previously deposited with Salinas Title by Orange, made up something more than the $190,000.00 purchase price for the Salinas property, and the excess was returned to the petitioners. Alloy's original deposit of $17,205.00 in the Orange escrow was returned to it sometime after August 28, 1957. (R. 23).

The petitioners paid approximately $10,000.00 into the Orange escrow for real estate commissions and escrow charges and paid for documentary stamps on the transfer of the Buena Park property to Alloy, and $471.80 into the Salinas escrow for fees and escrow charges together with cost of documentary stamps on the transfer of the Salinas property from Salinas Title to Alloy.

Alloy paid $106.38 to Orange for escrow charges and paid nothing to Salinas Title for escrow charges or stamps.

The Commissioner determined that the transfer of the Buena Park property to Alloy constituted a sale upon which petitioners realized a long term capital gain (R. 9) and the Tax Court sustained the decision of the Commissioner (R. 27) holding '* * * that the transactions in which petitioners disposed of the Buena Park property and acquired the Salinas property did not constitute an exchange within the meaning of Section 1031(a).'

In considering the question involved, there are certain findings of the Tax Court which this court believes to be particularly pertinent. Said findings are as follows:

> 'From the outset, petitioners desired to exchange their Buena Park property for other property of a like kind. They intended to sell the property for cash only if they were unable to locate a suitable piece of property to take in exchange.' (R. 20) (Emphasis ours.)
>
> 'The deposit by Alloy of $172,871.40 in the Salinas escrow was made by Elliott Pentz, an attorney, pursuant to the commitment of his client, Alloy. The funds were received from Alloy by Pentz; were the property of Alloy; and were deposited by him in Alloy's behalf.
>
> 'Alloy acquired title to the Salinas property solely to enable it to perform its agreement to exchange that property for the Buena Park property.' (R. 24) (Emphasis ours.)
>
> 'The Buena Park property and the Salinas property were of like kind.' (R. 24)

By the findings of the Tax Court, supra, it was determined that there was from the outset no intention on the part of the petitioners to sell the Buena Park property for cash if it could be exchanged for other property of like kind. There is no question that the desired property of like kind was located (Salinas property) and that, as determined by the findings, petitioners had no intention other than to exchange the Buena Park property for the Salinas property. It also follows from the findings that petitioners had no intention to purchase the Salinas property and that title to the Salinas property was to come to the petitioners by

exchange thereof for the Buena Park property. The intention of the parties and what actually occurred re the obtaining of the Salinas property for the exchange is further established by the finding that the $172,871.40 deposited by Alloy's attorney, Pentz, in the Salinas escrow was the 'property of Alloy' and deposited by Pentz 'in Alloy's behalf.' Further, 'Alloy acquired title to the Salinas property solely to enable it to perform its agreement to exchange the property for the Buena Park property.'

Respondent concedes that an exchange is not vitiated because cash is received in addition to property held for productive use or investment, but asserts that the $19,000.00 deposited by petitioners with Orange escrow was transmitted by Orange to Salinas escrow, whereas Alloy's initial deposit of $17,205.00 into the Orange escrow was returned by Orange to Alloy, and that if petitioners were not the purchasers of the Salinas property that Orange would have returned the $19,000.00 to petitioners and deposited the $17,205.00 with Salinas escrow in payment of the difference between the value of the Buena Park property and the purchase price of the Salinas property.

It is the position of respondent that from the facts and circumstances outlined above it must be concluded the Buena Park property was sold by petitioners to Alloy and the Salinas property was purchased chased by petitioners, not Alloy. However, it does not appear from the terms of the amended Orange escrow (August 19, 1957) that there was ever any obligation on the part of Alloy to pay cash for the Buena Park property of for the petitioners to receive cash for said property as provided in the May 21, 1957, escrow, by reason of the fact that prior to September 11, 1957, Alloy did deposit with Orange a deed to the Salinas property conveying same to petitioners. Neither liability of Alloy to petitioners for payment of cash for the Buena Park property nor liability of petitioners to sell the said property to Alloy for money ever matured because under no conditions was there to be a sale of the Buena Park property for cash until September 11, 1957, and then only if the Salinas property was not acquired by Alloy and exchanged for the Buena Park Property as of that date (R. 21). Deed of Alloy to petitioners conveying the Salinas property and deed of petitioners to Alloy conveying the Buena Park property were exchanged changed and recorded September 4, 1957. Consequently, an agreement on the part of petitioners to sell to Alloy the Buena Park property for money did not come into being.

Petitioners, on finding the Salinas property, took steps to make it available to Alloy for the exchange by signing buyer's instructions in the escrow of August 19, 1957, opened at Salinas Title, but the fact is, as found by the Tax Court, that petitioners at that time intended to accomplish an exchange of properties and that the Salinas property was 'acquired by Alloy' for the sole purpose of such exchange.

True, the intermediate acts of the parties could have hewn closer to and have more precisely depicted the ultimate desired result, but what actually occurred on September 3 or 4, 1957, was an exchange of deeds between petitioners and Alloy which effected an exchange of the Buena Park property for the Salinas property. It is also noted by the court that the buyer's instructions in the Salinas escrow did not conform to the seller's instructions although the transfer from the original owner of the Salinas property to Salinas Title was, as to the provision at variance, pursuant to the terms of the buyer's instructions. If Alloy had signed the said 'Buyer's Instructions' this litigation would have been avoided, but even in the circumstances here involved the court concludes that the intended exchange was accomplished.

Respondent argues the Tax Court found only that petitioners from the outset 'desired' to exchange their Buena Park property and not that from the outset they 'intended' to do so.

1This would appear in the circumstances to be a distinction without a difference since it does not seem logical that one would intentionally take steps to accomplish a result not desired, and that, therefore, all acts of the petitioners may be considered as having been performed with the intent to accomplish their desired result, to wit, 'exchange their Buena Park property for other property of a like kind.'. . . .

Referring again to the Salinas escrow and the instructions to Orange, it is to be noted that the terms of the buyer's instructions in the Salinas escrow and the instructions to Orange were not carried out in important details not heretofore mentioned. Although the petitioners authorized Orange to pay $19,000.00 into the Salinas escrow and to pay $171,000.00, when available, into the Salinas escrow, and although the Salinas escrow provided for the depositing of $171,000.00 into the Orange escrow (R.Br. 5), this was not done. The $171,000.00 nor any part thereof was ever paid into the Orange escrow, but on the contrary $172,871.40, property of Alloy, was by its attorney, Pentz, deposited in the Salinas escrow in Alloy's behalf.

The court concludes the holding of the Tax Court, 'that in essence petitioners acquired the Salinas property in a separate transaction; that payment of the $172,871.40, made by Alloy, was a payment made for petitioners' (R. 32), is not supported by the Tax Court's Findings of Fact, Stipulation of Facts or by the evidence in the case when considered in all of its aspects.

The court further concludes that there was no sale by petitioners of the Buena Park property to Alloy, but that the pertinent transactions resulted in an exchange of the Buena Park property for property of like kind to be held either for productive use in trade or for investment, and that by reason thereof there was no gain or loss from said exchange which should be recognized for income tax purposes. For the reasons set forth above, the Decision of the Tax Court of the United States Entered herein May 8, 1962, 'That there is a deficiency in the income tax for the taxable year 1957 in the amount of $39,530.58' (R. 33), is reversed.

Jordan Marsh Company v. Commissioner

269 F.2d 453 (2d Cir. 1959)

Before HINCKS, LUMBARD and MOORE, Circuit Judges.

HINCKS, Circuit Judge.

The transactions giving rise to the dispute were conveyances by the petitioner in 1944 of the fee of two parcels of property in the city of Boston where the petitioner, then as now, operated a department store. In return for its conveyances the petitioner received $2,300,000 in cash which, concededly, represented the fair market value of the properties. The conveyances were unconditional, without provision of any option to repurchase. At the same time, the petitioner received back from the vendees leases of the same properties for terms of 30 years and 3 days, with options to renew for another 30 years if the petitioner-lessee should erect new buildings thereon. The vendees were in no way connected with the petitioner. The rentals to be paid under the leases concededly were full and normal rentals so that the leasehold interests which devolved upon the petitioner were of no capital value.

In its return for 1944, the petitioner, claiming the transaction was a sale . . . sought to deduct from income the difference between the adjusted basis of the property and the cash received. The Commissioner disallowed the deduction, taking the position that the transaction represented an exchange of property for other property of like kind. Under [§1031] such exchanges are not occasions for the recognition of gain or loss; and even the receipt of cash or other property in the exchange of the properties of like kind is not enough to permit the taxpayer to recognize loss.[§1031(c)] Thus the Commissioner viewed the transaction, in substance, as an exchange of a fee interest . . . .

The controversy centers around the purposes of Congress in enacting [§1031], dealing with non-taxable exchanges. The section represents an exception to the general rule . . . that upon the sale or exchange of property the entire amount of gain or loss is to be recognized by the taxpayer. . . . Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in exchange. These considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose in enacting [§1031]. . .. That such indeed was the legislative objective is supported by Portland Oil Co. v. Commissioner of Internal Revenue, 1 Cir., 109 F.2d 479. There Judge Magruder, in speaking of a cognate provision contained§in 112(b), said at page 488:

> 'It is the purpose of Section 112(b)(5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture.'

In conformity with this reading of the statute, we think the petitioner here, by its unconditional conveyances to a stranger, had done more than make a change in the form of ownership: it was a change as to the quantum of ownership whereby, in the words just quoted, it had 'closed out a losing venture.' By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee. This, we hold, was a sale- not an exchange within the purview of [§1031].

The Tax Court apparently thought it of controlling importance that the transaction in question involved no change in the petitioner's possession of the premises: it felt that the decision in Century Electric Co. v. Commissioner of Internal Rev., supra, controlled the situation here. We think, however, that that case was distinguishable on the facts. For notwithstanding the lengthy findings made with meticulous care by the Tax Court in that case, 15 T.C. 581, there was no finding that the cash received by the taxpayer was the full equivalent of the value of the fee which the taxpayer had conveyed to the vendee-lessor, and no finding that the lease back called for a rent which was fully equal to the rental value of the premises. Indeed, in its opinion the Court of Appeals pointed to evidence that the fee which the taxpayer had 'exchanged' may have had a value substantially in excess of the cash received. And in the Century Electric case, the findings showed, at page 585, that the taxpayer-lessee, unlike the taxpayer here, was not required to pay 'general state, city and school taxes' because its lessor was an educational institution which under its charter was exempt from such taxes. Thus the leasehold interest in Century Electric on this account may well have had a premium value. In the absence of findings as to the values of the properties allegedly 'exchanged,' necessarily there could be no finding of a loss. And without proof of a loss, of course, the taxpayer could not prevail. Indeed, in the Tax Court six of the judges expressly based their concurrences on that limited ground. 15 T.C. 596.

In the Century Electric opinion it was said, 192 F.2d at page 159:

> 'Subsections 112(b)(1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See Fairfield S.S. Corp. v. Commissioner, 2 Cir., 157 F.2d 321, 323; Trenton Cotton Oil Co. v. Commissioner, 6 Cir., 147 F.2d 33, 36.'

But the Fairfield case referred to was one in which the only change in taxpayer's ownership was through the interposition of a corporate title accomplished by transfer to a corporation wholly owned by the taxpayer. And in the Trenton Cotton Oil case, the court expressly relied on Portland Oil Co. v. Commissioner of Internal Revenue, supra, as stating correctly the purpose of§112(b), but quoted only the first of the two requisites stated in Portland. As we have already observed, in that case Judge Magruder said that it was the purpose of§112(b) 'to intermit the claim of a loss' not only where the economic situation of the taxpayer is unchanged but also 'where * * * the taxpayer has not * * * closed out a losing venture.'[9] Here plainly the petitioner by the transfer finally closed out a losing venture. And it cannot justly be said that the economic situation of the petitioner was unchanged by a transaction which substituted $2,300,000 in cash for its investment in real estate and left it under a liability to make annual payments of rent for upwards of thirty years. Many bona fide business purposes may be served by such a transaction. Cary, Corporate Financing

through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv.L.Rev. 1.

In ordinary usage, an ‘exchange’ means the giving of one piece of property in return for another - not, as the Commissioner urges here, the return of a lesser interest in a property received from another. It seems unlikely that Congress intended that an ‘exchange’ should have the strained meaning for which the Commissioner contends. For the legislative history states expressly an intent to correct the indefiniteness of prior versions of the Act by excepting from the general rule ‘specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss.’

But even if under certain circumstances the return of a part of the property conveyed may constitute an exchange for purposes of§112, we think that in this case, in which cash was received for the full value of the property conveyed, the transaction must be classified as a sale. Standard Envelope Manufacturing Co. v. C.I.R., 15 T.C. 41; May Department Stores Co. v. C.I.R., 16 T.C. 547.

Reversed.

ESTATE of Frank D. STRANAHAN v. COMMISSIONER

472 F.2d 867 (6th Cir. 1973)

PECK, Circuit Judge.

* * * On March 11, 1964, the decedent, Frank D. Stranahan, entered into a closing agreement with the Commissioner of Internal Revenue Service (IRS) under which it was agreed that decedent owed the IRS $754,815.72 for interest due to deficiencies in federal income, estate and gift taxes regarding several trusts created in 1932. Decedent, a cash-basis taxpayer, paid the amount during his 1964 tax year. Because his personal income for the 1964 tax year would not normally have been high enough to fully absorb the large interest deduction, decedent accelerated his future income to avoid losing the tax benefit of the interest deduction. To accelerate the income, decedent executed an agreement dated December 22, 1964, under which he assigned to his son, Duane Stranahan, $122,820 in anticipated stock dividends from decedent's Champion Spark Plug Company common stock (12,500 shares). At the time both decedent and his son were employees and shareholders of Champion. As consideration for this assignment of future stock dividends, decedent's son paid the decedent $115,000 by check dated December 22, 1964. The decedent thereafter directed the transfer agent for Champion to issue all future dividend checks to his son, Duane, until the aggregate amount of $122,820 had been paid to him. Decedent reported this $115,000 payment as ordinary income for the 1964 tax year and thus was able to deduct the full interest payment from the sum of this payment and his other income. During decedent's taxable year in question, dividends in the total amount of $40,050 were paid to and received by decedent's son. No part of the $40,050 was reported as income in the return filed by decedent's estate for this period. Decedent's son reported this dividend income on his own return as ordinary income subject to the offset of his basis of $115,000, resulting in a net amount of $7,282 of taxable income.

Subsequently, the Commissioner sent appellant (decedent's estate) a notice of deficiency claiming that the $40,050 received by the decedent's son was actually income attributable to the decedent. After making an adjustment which is not relevant here, the Tax Court upheld the deficiency in the amount of $50,916.78. The Tax Court concluded that decedent's assignment of future dividends in exchange for the present discounted cash value of those dividends "though conducted in the form of an assignment of a property right, was in reality a loan to [decedent] masquerading as a sale and so disguised lacked any business purpose; and, therefore, decedent realized taxable income in the year 1965 when the dividend was declared paid."

As pointed out by the Tax Court, several long-standing principles must be recognized. First, under Section 451(a), a cash basis taxpayer ordinarily realizes income in the year of receipt rather than the year when earned. Second, a taxpayer who assigns future income for consideration in a bona fide commercial transaction will ordinarily realize ordinary income in the year of receipt. Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958); Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941). Third, a taxpayer is free to arrange his financial affairs to minimize his tax liability; thus, the presence of tax avoidance motives will not nullify an otherwise bona fide transaction. We also note there are no claims that the transaction was a sham, the purchase price was inadequate or that decedent did not actually receive the full payment of $115,000 in tax year 1964. And it is agreed decedent had the right to enter into a binding contract to sell his right to future dividends.

The Commissioner's view regards the transaction as merely a temporary shift of funds, with an appropriate interest factor, within the

family unit. He argues that no change in the beneficial ownership of the stock was effected and no real risks of ownership were assumed by the son. Therefore, the Commissioner concludes, taxable income was realized not on the formal assignment but rather on the actual payment of the dividends.

It is conceded by taxpayer that the sole aim of the assignment was the acceleration of income so as to fully utilize the interest deduction. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), established the landmark principle that the substance of a transaction, and not the form, determines the taxable consequences of that transaction. In the present transaction, however, it appears that both the form and the substance of the agreement assigned the right to receive future income. What was received by the decedent was the present value of that income the son could expect in the future. On the basis of the stock's past performance, the future income could have been (and was) estimated with reasonable accuracy. Essentially, decedent's son paid consideration to receive future income. Of course, the fact of a family transaction does not vitiate the transaction but merely subjects it to special scrutiny.

We recognize the oft-stated principle that a taxpayer cannot escape taxation by legally assigning or giving away a portion of the income derived from income producing property retained by the taxpayer. Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940); Commissioner v. P. G. Lake, Inc., *supra*. Here, however, the acceleration of income was not designed to avoid or escape recognition of the dividends but rather to reduce taxation by fully utilizing a substantial interest deduction which was available.[FN6] As stated previously, tax avoidance motives alone will not serve to obviate the tax benefits of a transaction. Further, the fact that this was a transaction for good and sufficient consideration, and not merely gratuitous, distinguishes the instant case from the line of authority beginning with Helvering v. Horst, *supra*. * * *

FN6. By accelerating income into the year 1964, when it would be offset by the interest deduction, decedent could reduce his potential tax liability for the future years in which the dividends would be paid.

The Commissioner also argues that the possibility of not receiving the dividends was remote, and that since this was particularly known to the parties as shareholders and employees of the corporation, no risks inured to the son. The Commissioner attempts to bolster this argument by pointing out that consideration was computed merely as a discount based on a prevailing interest rate and that the dividends were in fact paid at a rate faster than anticipated. However, it seems clear that risks, however remote, did in fact exist. The fact that the risks did not materialize is irrelevant. Assessment of the risks is a matter of negotiation between the parties and is usually reflected in the terms of the agreement. Since we are not in a position to evaluate those terms, and since we are not aware of any terms which dilute the son's dependence on the dividends alone to return his investment, we cannot say he does not bear the risks of ownership.

Accordingly, we conclude the transaction to be economically realistic, with substance, and therefore should be recognized for tax purposes even though the consequences may be unfavorable to the Commissioner. The facts establish decedent did in fact receive payment. Decedent deposited his son's check for $115,000 to his personal account on December 23, 1964, the day after the agreement was signed. The agreement is unquestionably a complete and valid assignment to decedent's son of all dividends up to $122,820. The son acquired an independent right against the corporation since the latter was notified of the private agreement. Decedent completely divested himself of any interest in the dividends and vested the interest on the day of execution of the agreement with his son. * * *

The judgment is reversed and the cause remanded for further proceedings consistent with this opinion.

Pittsburgh's Persian Princess; Princess Farid-es-Sultaneh

By Janet Kettering Originally published in *The* Homewood, newsletter of The Homewood Cemetery Historical Fund.

At first glance, her life seemed to be what dreams are made of: luxurious residences in Paris and New York, a priceless collection of jewels, world-wide travel to exotic ports of call, great wealth, and a handsome prince. But her Cinderella-like life did not, like the fairy tale, end happily ever after.
Doris Mercer, the daughter of a Pittsburgh police captain, was born circa 1889. As a child, she acquired a love of music at the knee of her pianist mother who often accompanied her as she sang. She grew into a talented, beautiful young woman. Not content with life in Pittsburgh, Doris ran away from home at the age of eighteen to seek fame and fortune on the operatic stage. Her father later found her in New York City performing a minor role on Broadway in the musical The Earl and the Girl. In hope of redirecting her life, he placed her in a church school, but she again escaped and returned to New York City. Eventually she met and married an older man, publisher Percival Harden. The marriage ended in divorce in 1919.

In 1924 she married again, becoming the second wife of Sebastian S. Kresge, a multimillionaire chain store founder more than twenty years her senior. Mr. Kresge, a merchandising genius, was known for his penchant for hard work, his opposition to the use of alcohol, tobacco and card playing, and his eccentric passion for frugality. Although his personal fortune was estimated at two hundred million, he reportedly lined his worn shoes with paper and wore inexpensive suits until they were threadbare. In spite of his personal parsimony, Mr. Kresge was a dedicated philanthropist, believing that men of wealth were obligated to return to society the money they had amassed. He attempted to please his young wife by professing an interest in her love of opera and her Fifth Avenue lifestyle, but the "old school gentleman" and the high-spirited Doris were a mismatch. Their brief and stormy marriage failed. His pinch-penny attitudes and her refusal to bear children were among the bitterly fought issues of their highly publicized divorce in 1928. Mrs. Kresge reportedly received a three million dollar settlement.

The wealthy divorcee set sail for Europe and settled in an aristocratic residential section of Paris overlooking the Seine. She again pursued her vocal career and enjoyed attending the opera and receptions with a close circle of friends. The beautiful American woman of means attracted the eye of Prince Farid Khan Sadri-Kajar, a relative of Persian royalty who lived in a nearby villa. A friendship and romance developed. In letters to her family in Pittsburgh, Doris described her suitor as closely resembling the film star Ramon Navarro. Although flattered by his attention, she was reluctant to consider marriage again, but the Prince was persistent and she eventually agreed to become his wife. The Prince's family sent its blessings and gave betrothal gifts consisting of a necklace, bracelet, ring, and pin of exquisite emeralds and pearls.

In 1933, Doris Kresge became a Persian Princess in a Moslem mosque in Paris. After an extended honeymoon in Egypt, India and the Far East, the newlyweds returned to Paris where their luxurious lifestyle and long-standing friendship seems to ensure a happy life. But within two years, the prince and

Princess were divorced. It was rumored that the handsome Prince was in reality a “playboy Prince” who was more interested in his wife’s money than her beauty and charm.

In 1940, Princess Farid-es-Sultaneh (a title she retained, against the Prince’s wishes, until her death) returned to America and purchased Glen Alpin, a sixteen-acre private estate near Morristown, New Jersey, with an impressive history dating back to a land grant from King George in 1758. The estate’s handsome sixteen-room stone mansion, (built circa 1840) cited today as one of the finest Gothic Revival buildings in New Jersey, is still locally referred to as “the Princess mansion.” Among its amenities were nine baths, a guest cottage, a six-car garage, eight fireplaces, hand painted murals, a library, a music room, and a glass conservatory. The graves of the original pre-Revolutionary war owners of the estate lie in a grove of trees in the sprawling front yard.

The Princess never remarried, and her reclusive life at the mansion became increasingly precarious as she weathered a decade of court battles. She was robbed of nearly one hundred thousands dollars of jewels, swindled by a master con man, and sued for bad debts. In 1949, the Princess ordered an exhibition and public sale of her valuable furnishings at Glen Alpin in an attempt to recoup her financial losses. According to one newspaper account, “the Princess sat almost unobserved...while [the] auctioneer...pacingly chanted off the merchandise from the Alpine’s [sic] palatial front stoop.” Among the items sold for a fraction of their value was a half-a-room-wide Steinway concert piano inlaid with gold leaf. Reputedly, an exact duplicate was owned by Barbara Hutton and another was in the White House.

In 1959, the Princess, nearly broke and virtually alone, was diagnosed with chronic lymphatic leukemia. During her final years, she sought solace in religion and the Bible. In 1960, she sold a portion of land across the street from her mansion to the Seventh Day Adventists. A church was erected on the site, and she joined the congregation where she charmed the parishioners with her operatic renditions of church hymns. She died in Morristown, New Jersey, on August 12, 1963, at the age of seventy-four. Princess Farid- es-Sultaneh was brought home and buried beside her mother, Jennie S. Mercer in the shade of a sycamore tree in The Homewood Cemetery in Section 9.3, Lot 187. Sadly, the woman who lived such an extraordinary life lies in an unmarked grave. Her obituary stated that “As death came, a romantic title and a lonely mansion...were all that remained of her fairy-tale life.” As much of her intriguing life has been lost to history, perhaps she should be remembered by her own words: “I have no regrets. My life has been exciting, and I wouldn’t have wanted it any other way.”

Boyter v. Commissioner
74 T.C. 989 (1980)

WILBUR, Judge:

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Petitioners were married in Baltimore, Md., on April 2, 1966. For the years 1966 through 1974 inclusive, they filed Federal income tax returns as a married couple, filing either jointly, or as married individuals filing separately. Petitioners reside in a home which they purchased as tenants by the entirety on October 26, 1967. Petitioners also acquired real property located in Calvert County, Md., as tenants by the entirety on December 23, 1969.

Petitioners discovered that their tax liability would be lowered if they filed their returns as single persons and investigated the possibility of obtaining yearend divorces. Petitioner Angela Boyter went to a library in Baltimore, Md., located the name of seven Haitian attorneys, and contacted each seeking estimates. Petitioners traveled to Haiti in late 1975. They obtained a divorce decree from the Republic of Haiti on December 8, 1975. **** After returning from Haiti, petitioners obtained a marriage certificate from Howard County, Md., on January 9, 1976.

In November of 1976, petitioners traveled to the Dominican Republic. They obtained a divorce decree from the Dominican Republic on November 22, 1976. **** On February 10, 1977, petitioners again obtained a marriage certificate from Howard County, Md.

Petitioners sought and obtained their divorce decrees solely in order to render themselves unmarried as of December 31 for the years 1975 and 1976 so that they could file income tax returns as unmarried individuals. Petitioners never intended to and never did physically separate from each other prior to or subsequent to either of the divorces. Rather, they have continued to reside together in the home they purchased in 1967. At all times during 1975 and 1976, petitioners were domiciled in Maryland.****

We are called upon to decide a rather unique and controversial case involving two individuals who availed themselves of perfunctory yearend divorces in foreign countries in order to render themselves unmarried for the purposes of the tax law. The monetary savings from such an endeavor stem from the differing rate schedules for married persons and single persons and the interplay of a progressive tax structure with income aggregation for married couples.****

The precise issue for our decision is whether petitioners are entitled to file as single individuals for the tax years 1975 and 1976. Respondent contends that petitioners were married individuals for those years because: (1) The foreign divorces would not be recognized as valid in Maryland, the State in which petitioners reside, since the foreign courts did not have subject matter jurisdiction over the divorce proceedings; (2) the divorces would not be recognized as valid in Maryland because petitioners made material misrepresentations to the foreign courts, thereby perpetrating a fraud on the courts; and (3) even if the divorce decrees are recognized as valid for State law purposes, they should be disregarded for Federal income tax purposes because a yearend divorce whereby the parties intend to, and do in fact, remarry early in the next year is a sham transaction that may be disregarded for Federal income tax purposes.

Conversely, petitioners maintain that they are entitled to file as single individuals because they obtained valid foreign divorces, recognizable in Maryland, which rendered them unmarried on December 31 of both years. Furthermore, petitioners argue that the divorces were not shams because there are substantial nontax effects emanating from their divorced status, and that, in any event, the cases dealing with sham

transactions are inapplicable to the determination of marital status. We agree with respondent that Maryland would not recognize the foreign divorces as valid because the foreign courts lacked subject matter jurisdiction over the divorce proceedings.

We also agree with the assertion emphatically made by respondent on brief that "the Tax Court is bound by state law rather than federal law when attempting to construe marital status." Except in a few specific situations, the definition of "husband and wife," or "marriage" is not addressed in the Internal Revenue Code, even though the application of many provisions of the statute turns on the marital status of the taxpayer. It has consistently been held that for Federal income tax purposes, the determination of the marital status of the parties must be made in accordance with the law of the State of their domicile. ****

Unfortunately, from our standpoint, the law in Maryland with regard to the recognition of migratory divorces obtained in a foreign country by Maryland domiciliaries has not been explicitly declared by either the legislature or the highest court of that State. In fact, neither the parties nor we can find even a lower court decision which rules on the validity of a divorce such as this one, where admittedly both parties remained domiciled in Maryland throughout the divorce proceedings. The absence of a definitive answer to our dilemma from the courts in Maryland, however, does not allow us either to avoid this necessary determination or to simply decide what we ourselves think the rule ought to be. Rather, we must choose the rule we believe the highest State court would adopt if faced with the question. ****

It appears reasonably clear to us in surveying the traditional notions of what empowers a tribunal to render a valid divorce decree and the way in which migratory foreign divorces have been viewed in other States, that Maryland would not recognize the Haitian and Dominican divorces as valid. ****

There is no question that throughout the foreign divorce proceedings, the Boyters resided and were domiciled in Maryland. Indeed, the divorce decrees of both foreign countries state this fact. And although the precise issue of the recognition of a divorce obtained in a foreign country in which both parties participate has not come before the Maryland courts, we believe that, if faced with the question, Maryland's highest court would follow the rule that domicile of one of the parties is necessary in order for a judgment of divorce by a foreign tribunal to be recognized as valid under principles of comity.

Petitioners argue that respondent should not be allowed to attack the validity of the foreign divorces in the Tax Court because such an attack is proper only where there are conflicting judicial decrees regarding the taxpayers' marital status. We do not share this view. Congress chose to enact separate rate schedules the application of which is entirely dependent upon whether the taxpayer is single or married. Clearly, in enforcing these provisions, the respondent has not only the right, but the duty, to determine the marital status of the taxpayer, and we have so held. ****

Petitioners, at all times, remained residents and domiciliaries of Maryland. Because State law is determinative on the issue of marital status and because Maryland would not recognize the foreign divorces as valid to terminate the marriage, petitioners are not entitled to file their tax returns as single persons for the years 1975 and 1976.

26 C.F.R. § 1.446–1(e), Treas. Reg. §1.446–1(e)

(e) Requirement respecting the adoption or change of accounting method. (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.460–4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and § 1.1016–3(h).

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(d) Changes involving depreciable or amortizable assets—(1) Scope. This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)).

(2) Changes in depreciation or amortization that are a change in method of accounting. Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(i) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(ii) A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d), for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–2 C.B. 119), Notice 2006–77 (2006–40 I.R.B. 590), and § 601.601(d)(2)(ii)(b) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

(iii) A change from claiming the 30–percent additional first year depreciation deduction to claiming the 50–percent additional first year depreciation deduction for depreciable property that qualifies for the 50–percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30–percent, instead of the 50–percent, additional first year depreciation deduction (for example, 50–percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50–percent additional first year depreciation deduction to claiming the 30–percent additional first year depreciation deduction for depreciable property that qualifies for the 30–percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30–percent, instead of the 50–percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

(iv) A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(v) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Internal Revenue Code (for example, § 1.197–2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(vi) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(vii) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term mass assets means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(viii) Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(3) Changes in depreciation or amortization that are not a change in method of accounting. Section 1.446–1(e)(2)(ii)(b) applies to determine whether a change in depreciation or amortization is not a change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

(i) Useful life. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is not a change in method of accounting. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 168(g)(2) or (3), section 197), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies). See paragraph (e)(2)(ii)(d)(5)(iv) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

(ii) Change in use. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(iii) Elections. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an election under section 179 of the Internal Revenue Code, see section 179(c) and § 1.179–5.

(iv) Salvage value. Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(v) Placed-in-service date. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2)(i) of this section. See paragraph (e)(2)(ii)(d)(5)(v) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.

(vi) Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(4) Item being changed. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under § 1.167(a)–11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is permitted only with respect to all assets in a particular account (as defined in § 1.167(a)–7) or vintage account.

(5) Special rules. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies—

(i) Declining balance method to the straight line method for MACRS property. For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200–percent or 150–percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87–57 (1987–2 C.B. 687) and § 601.601(d)(2)(ii)(b) of this chapter).

(ii) Depreciation method changes for section 167 property. For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))), see § 1.167(e)–1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see § 1.167(a)–11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see § 1.167(a)–11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

(iii) Section 481 adjustment. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97–27 (1997–1 C.B. 680), section 2.06 of Rev. Proc. 2002–9 (2002–1 C.B. 327), and § 601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(iv) Change in useful life. This paragraph (e)(2)(ii)(d)(5)(iv) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) and

that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this adjustment in useful life, no section 481 adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)–1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)–1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

(v) Change in placed-in-service date. This paragraph (e)(2)(ii)(d)(5)(v) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this change in placed-in-service date, no section 481 adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(iii) Examples. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39–year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2003 as 5–year property under section 168(e) and depreciated on A1's 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200–percent declining balance method of depreciation, a 5–year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15–year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150–percent declining balance method, a 15–year recovery period, and the half-year convention. In 2010, the IRS examines B's 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20–year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or

business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38 (2000–2 C.B. 310) and § 601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2)(vi) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7–year property under section 168(e). F elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200–percent declining balance method of depreciation, a 7–year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5–year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5–year recovery period rather than a 7–year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under § 1.167(a)–3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2003, H, a calendar year taxpayer, purchased and placed in service "off-the-shelf" computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5–year property under section 168(e). On its 2003 Federal tax return, H elected to depreciate its 5–year property placed in service in 2003 under the alternative depreciation system of section 168(g) and H elected not to deduct the additional first year depreciation provided by section 168(k). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5–year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36–month useful life, and a monthly

convention. H's change from 5–years to 36–months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5–year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k)(2). I2 did not place in service any other depreciable property in 2003. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5–year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30–percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200–percent declining balance method, a 5–year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, "Application for Change in Accounting Method," to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under § 301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

Example 18. On December 1, 2004, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its "suspense" account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, J's change in the treatment of the adding machines from nondepreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(d)(3)(v) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 adjustment.

Example 19. In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have began in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(d)(3)(v) of this section, K's change in the placed-in-service date of the equipment is not a change in method of accounting.

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer generally must file an application on Form 3115, "Application for Change in Accounting Method," with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§ 1.381(c)(4)–1(d)(2) and 1.381(c)(5)–1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) applies. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer's

method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see § 1.446–1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see § 1.446–1(e)(3) in effect prior to December 31, 1997 (§1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) Effective date—(i) In general. Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii), and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.446–1(e) in effect prior to December 30, 2003 (§ 1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) Changes involving depreciable or amortizable assets. With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) Examples 9 through 19 of this section, and the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" in the last sentence of paragraph (e)(2)(ii)(a) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

(iii) Effective/applicability date for paragraph (e)(3)(i). The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

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[Prior Sections that deal with Methods to Obtain Consent and Designation of Areas where Automatic Consent is Available and when Consent is Not Automatic are omitted]

SECTION 7. TERMS AND CONDITIONS OF CHANGE

.01 In general. A change in method of accounting requested under this revenue procedure for which consent is granted must be implemented pursuant to both the terms and conditions provided in this revenue procedure and either the List of Automatic Changes (in the case of an automatic change) or the letter ruling for the change (in the case of a non-automatic change). Notwithstanding the terms and conditions in this revenue procedure, based on the unique facts of a particular case and in the interest of sound tax administration, the national office may prescribe in the letter ruling for a non-automatic change terms and conditions for the requested change in method of accounting that differ from and override those provided in this revenue procedure.

.02 Section 481(a) adjustment. Except as otherwise provided in this revenue procedure, the List of Automatic Changes (in the case of an automatic change), a letter ruling to the taxpayer (in the case of a non-automatic change), or other guidance published in the IRB, a taxpayer making a change in method of accounting under this revenue procedure must apply § 481(a) and take into account the § 481(a) adjustment in the manner provided in SECTION 7.03. See SECTION 2.06(1); but see SECTION 13.01(3).

.03 Section 481(a) adjustment period.

(1) In general. Except as otherwise provided **[Editor note: exceptions deal with involuntary changes and other special situations]** * * *, the § 481(a) adjustment period is one taxable year (year of change) for a negative § 481 (a) adjustment **[Editor note: negative means reduction in taxable income]** and four taxable years (year of change and next three taxable years) for a positive § 481(a) adjustment **[Editor Note: positive means increase in taxable income]**.

SECTION 8. AUDIT PROTECTION FOR TAXABLE YEARS PRIOR TO YEAR OF CHANGE

.01 In general. Except as provided in SECTION 8.02 or under any other guidance published in the IRB, when a taxpayer timely files a Form 3115 under this revenue procedure, the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change.

.02 Exceptions. SECTION 8.01 does not apply if any exception in SECTIONS 8.02(1) through 8.02(7) applies.

(1) No audit protection for taxpayers under examination. Except as provided in SECTIONS 8.02(1)(a) through (f), the IRS may require the taxpayer to change its method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the taxpayer is under examination as of the date the taxpayer files the Form 3115.

(a) Change filed in a three-month window.

(i) In general. Except as provided in SECTION 8.02(1)(a)(iii), SECTION 8.02(1) (no audit protection for taxpayers under examination) does not apply to a request for a change in method of accounting for an item filed in a three-month window if (1) the taxpayer has been under examination for at least 12 consecutive months as of the first day of the three-month window, and (2) the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration as described in SECTION 3.08 as of the date the taxpayer files the Form 3115.

(ii) Three-month window. A “three-month window” is the period beginning on the fifteenth day of the seventh month of the taxpayer’s taxable year and ending on the fifteenth day of the tenth month of the taxpayer’s taxable year. However, if the taxable year is a short taxable year that ends before the fifteenth day of the tenth month after the short taxable year begins, the ““three-month window” is the period beginning on the first day of the second month preceding the month in which the short

taxable year ends and ending on the last day of the short taxable year.

* * * * .

(iv) Statement required. The Form 3115 must include a statement that the Form 3115 is filed under a three-month window in SECTION 8.02(1)(a) of Rev. Proc. 2015-13.

(b) Change filed in a 120-day window. (i) In general. Except as provided in SECTION 8.02(1)(b)(iii), SECTION 8.02(1) (no audit protection for taxpayers under examination) does not apply to a request for a change in method of accounting for an item filed in a 120-day window if the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration as described in SECTION 3.08 as of the date the taxpayer files the Form 3115. However, the 120-day window ends on the date the IRS notifies the taxpayer that jurisdiction for the case has been transferred from Appeals to the examining agent(s) for reconsideration. See SECTION 3.18(1)(c).

(ii) "120-day window. A "120-day window" is the 120-day period following the date an examination of the taxpayer ends, regardless of whether a subsequent examination has commenced.

* * * *

(e) Change resulting in a negative § 481(a) adjustment.

(i) In general. SECTION 8.02(1) (no audit protection for taxpayers under examination) does not apply to a change in method of accounting for an item that:

(A) results in a negative § 481(a) adjustment for that item for the year of change; and

(B) would have resulted in a negative § 481(a) adjustment in each taxable year under examination if the change in method of accounting for that item had been made in the taxable year(s) under examination.

(2) Change lacking audit protection. The IRS may change a taxpayer's method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the description of the change in the List of Automatic Changes, or other guidance published in the IRB, provides that the change is not subject to the audit protection provisions of SECTION 8.01.

* * * *

(6) Criminal investigation. The IRS may change a taxpayer's method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if there is any pending or future criminal investigation or proceeding concerning (i) directly or indirectly, any issue relating to the taxpayer's federal tax liability for any taxable year prior to the year of change, or (ii) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change.

(7) Issue under consideration. The IRS may change a taxpayer's method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the taxpayer's method of accounting for the same item is an issue under consideration pursuant to SECTION 3.08 as of the date the taxpayer filed the Form 3115. However, for a CFC or 10/50 corporation, the preceding sentence does not apply to an item to which SECTION 8.02(1) (no audit protection for taxpayers under examination) ceases to apply pursuant to SECTION 8.02(1) (f)(ii) or that is the subject of a Form 3115 filed in a three-month window pursuant to SECTION 8.02(1)(a)(iii).

(8) Prior year IRS-initiated change. The IRS may make adjustments to the taxpayer's returns for the same item for taxable years prior to the requested year of change to reflect a change in method of accounting imposed by the IRS for a prior taxable year pursuant to Rev. Proc. 2002 18 (or successor).

Rev. Proc. 2002-18, 2002-1 CB 678

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5. Examination Discretion To Resolve Accounting Method Issues * * * *

.04. Terms and Conditions of Change.

(1) *Year of change.* An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible. However, in appropriate circumstances, an examining agent may defer the year of change to a later taxable year. For example, an examining agent may defer the year of change if the examining agent determines that:

(a) the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment for the taxable year in which the change would otherwise be imposed and the adjustment cannot be reasonably estimated;

(b) the taxpayer's existing method of accounting does not have a material effect for the taxable year in which the change would otherwise be imposed; or

(c) there are taxable years for which the statute of limitations has expired following the taxable year in which the change would otherwise be imposed. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change.

(2) *Section 481(a) adjustment.* An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). However, an examining agent should use a cut-off method to make a change (other than a change within the LIFO inventory method as defined in section 3.09 of Revenue Procedure 97-27, 1997-1 C.B. 680, or a change in method of accounting for intercompany transactions, *see*§ 1.1502-13) when a statute, regulation or administrative pronouncement of the Service effective for the year of change directs that the change be made using a cut-off method. *See, e.g.*, § 174. In addition, an examining agent may use a cut-off method to make a change in appropriate circumstances. For example, the examining agent may use a cut-off method to make a change if the agent determines that the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment and the adjustment cannot be reasonably estimated. Finally, an examining agent will not make a change on a cut-off method in order to reflect the hazards of litigation.

(3) *Spread of § 481(a) adjustment.* The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change.

6. Appeals And Counsel For The Government Discretion To Resolve Accounting Method Issues

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.02. Types of Resolutions.

(1) *In general*. An appeals officer or counsel for the government may resolve an accounting method issue by using any of the means described in section 6 of this revenue procedure, or any other means deemed appropriate under the circumstances, to reflect the hazards of litigation. See sections 10.02 through 10.04 of this revenue procedure for examples of the application of section 6 of this revenue procedure.

(2) *Accounting method changes*

(a) *Treating an accounting method issue as a method change.* An appeals officer or counsel for the government resolving an accounting method issue may treat the issue as a change in method of accounting.

(b) *Selection of new method of accounting*. Except as provided in section 2.06 of this revenue procedure, an appeals officer or counsel for the government changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts. The appeals officer or counsel for the government will not put the taxpayer on an improper method of accounting in order to reflect the hazards of litigation.

(c) *Terms and conditions of change.* An appeals officer or counsel for the government changing a taxpayer's method of accounting may agree to terms and conditions that differ from those ordinarily applicable to an Examination-imposed accounting method change, including the following (or any combination thereof):

(i) *Year of change*. An appeals officer or counsel for the government may compromise the year of change (for example, by agreeing to a later year of change). However, an appeals officer or counsel for the government changing a taxpayer's method of accounting ordinarily will not defer the year of change to later than the most recent taxable year under examination on the date of the agreement finalizing the change, and, in no event, will defer the year of change to later than the taxable year that includes the date of the agreement finalizing the change;

(ii) *Section 481(a) adjustment.* An appeals officer or counsel for the government may make the change using a § 481(a) adjustment or a cut-off method. If a § 481(a) adjustment is used, the appeals officer or counsel for the government may compromise the amount of the § 481(a) adjustment (for example, by agreeing to a reduced § 481(a) adjustment). If the appeals officer or counsel for the government agrees to compromise the amount of the § 481(a) adjustment, the agreement must be in writing; and

(iii) *Spread of the* § *481(a) adjustment.* An appeals officer or counsel for the government may compromise the § 481(a) adjustment period (for example, by agreeing to a longer § 481(a) adjustment period).