FEDERAL INCOME TAXATION

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During the current survey period, the Fifth Circuit issued opinions in thirty-one cases involving federal taxation issues. Of these, nine cases dealt with tax protestors, five with tax fraud prosecutions, and one with selling an abusive and sham tax shelter.

I. ABANDONMENT OF PROPERTY AS A "SALE OR EXCHANGE"

The Fifth Circuit treated an abandonment of property as a "sale or exchange" in Yarbro v. Commissioner,1 extending the rationale of prior court decisions characterizing foreclosure sales to be sales or exchanges of property even though no consideration was received other than the cancellation of a debt.2 As a result, the taxpayer in Yarbro had a capital loss rather than an ordinary loss on the abandonment of his property.

A sale at foreclosure and the abandonment of property subject to a mortgage raise questions both as to the amount of any gain or loss on the transaction and the characterization of the gain or loss.3 While a logical approach would be to separate the transaction into two events—one involving the liability that has been cancelled and the other the sale or exchange of the property—this bifurcation approach was rejected by the Supreme Court in Commissioner v. Tufts.4 A comparison of the two approaches (the sale or exchange theory and the bifurcation approach) is nonetheless warranted, as a strict application of the sale or exchange theory can render harsh results for taxpayers in dire financial straits who attempt to satisfy their creditors by transferring property to satisfy the indebtedness or, as in the Yarbro case, by abandoning the property without a conveyance, thereby per-

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2. See, e.g., Helvering v. Hammel, 311 U.S. 504, 510 (1941) (loss sustained by individual taxpayer upon foreclosure sale of interest in real estate which he had acquired for profit held deductible only to limited extent allowed by §§ 23(j) and 117(d) for losses from sales or exchanges of capital assets).
mitting the creditor to obtain the property pursuant to foreclosure proceedings.

The Supreme Court early decided that a foreclosure sale was a sale or exchange of property, determining that the involuntary nature of the transaction and the lack of any surplus from the sale to be returned to the mortgagor had no significance.\(^5\) According to the Supreme Court the fact that the property was subject to a nonrecourse mortgage and was worth less than the mortgage would not change the result.\(^6\) The Seventh Circuit later determined that a conveyance of property to the mortgagee by a quitclaim deed in lieu of a foreclosure sale would be treated the same as if a foreclosure had occurred.\(^7\) The Eleventh Circuit affirmed the Tax Court's application of this rationale to the abandonment of property subject to a nonrecourse mortgage in *Middleton v. Commissioner*.\(^8\) Then, in *Yarbro v. Commissioner*,\(^9\) the Fifth Circuit adopted the concept, noting that a taxpayer should not be able to avoid the tax consequences of a foreclosure sale "by the simple expedient of [abandoning] the property before the mortgagee can foreclose."\(^10\)

The taxpayer in *Yarbro* had a loss on the transaction; an abandonment of property subject to a mortgage or a sale at foreclosure can produce a gain. If the transaction is characterized as a sale or exchange, the "amount realized" from the transaction determines the amount of gain or loss.\(^11\) The Supreme Court in *Commissioner v. Tufts*\(^12\) held that the amount realized on the disposition of property subject to a nonrecourse mortgage included the outstanding amount of the obligation; the fair market value of the property was irrelevant to the calculation.\(^13\) The Supreme Court reversed the Fifth Circuit's decision in *Tufts* which had determined that amount realized on disposition of property subject to a nonrecourse mortgage should be lim-

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8. *77 T.C. 310, 320-21 (1981), aff'd, 693 F.2d 124 (11th Cir. 1982).*
9. *737 F.2d 479 (5th Cir. July 1984).*
10. *Id. at 486* (quoting *Laport v. Commissioner*, 671 F.2d at 1033).
11. *See I.R.C. § 1001(b) (1982).*
12. *461 U.S. 300 (1983).*
13. *Id. at 307.* The Tax Reform Act of 1984 (P.L. 98-369) added § 7701(g) to the Code to codify the *Tufts* decision.
ited to fair market value of the property. In a concurring opinion, Justice O'Connor recognized that realities of the transaction would cause fair market value of the property to be the amount realized on the transaction rather than amount of the mortgage. As Justice O'Connor stated, "the benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than the fair market value of the property." Thus, fair market value of the property less the taxpayer's adjusted basis should determine gain on the exchange. The difference between the amount of the mortgage and the fair market value of the property would be income from discharge of indebtedness. While recognizing the logic of the bifurcated approach, Justice O'Connor agreed with the majority that the Supreme Court should not adopt that approach judicially because the Commissioner's interpretation of the statute was defensible.

The reason for separating the two aspects of the transaction is that the two types of income are treated differently in the Internal Revenue Code (Code). Income from discharge of indebtedness can be deferred if the taxpayer elects to reduce the basis in depreciable property or, in the case of an insolvent taxpayer, is not taxable income to the extent of insolvency. Assume a taxpayer has an adjusted basis in his property of $30,000 (the cost having been reduced by depreciation deductions). The property is subject to a mortgage of $100,000 which the taxpayer is unable to pay. If the mortgagor forecloses on the property, the taxpayer will have a taxable gain of $70,000 ($100,000 (amount of the mortgage) less $30,000 (basis in the property)), because the transaction is treated exclusively as a sale or exchange. Assume the property is worth only $50,000. The taxpayer would still have taxable income of $70,000. Further, even though the taxpayer

15. 461 U.S. at 318 (O'Connor, J., concurring). Section 1001(b) of the Internal Revenue Code (Code) provides that amount realized is the sum of money received plus "fair market value of property (other than money) received." I.R.C. § 1001(b) (1985) (emphasis added). However, see § 7701(g) of the Code added by the Tax Reform Act of 1984 (P.L. 98-369) which provides that for purposes of determining the amount of gain or loss on the sale of property, fair market value shall be treated as not being less than the amount of any nonrecourse indebtedness to which the property is subject.
17. See United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).
20. This result occurs because of Commissioner v. Tufts, 461 U.S. 300 (1983).
abandoned the property, he would have a $70,000 taxable gain. However, if the transaction were separated, as suggested in the concurring opinion in *Tufts*, the taxpayer would have a capital gain of only $20,000 ($50,000 (fair market value of the property) less $30,000 (basis in the property)), plus income from discharge of indebtedness of $50,000 ($100,000 (amount of the mortgage) less $50,000 (fair market value of the property)). The $50,000 income from discharge of indebtedness would not be taxable income if the taxpayer remained insolvent after the transaction or, if the taxpayer became solvent as a result of the discharge, the gain could be deferred by reducing basis in other assets. Thus, the taxpayer in financial straits would not be saddled with substantial taxable income.

Characterization of the abandonment of property subject to a mortgage (including a nonrecourse mortgage) as a sale or exchange of property, coupled with the decision of the Supreme Court in *Tufts* that the amount realized on such a sale or exchange is the amount of the mortgage, may force more insolvent taxpayers to utilize the bankruptcy proceedings since discharge of indebtedness through bankruptcy is not taxable income.

II. LESSOR'S DEPRECIATION DEDUCTION LIMITED TO “SIGNIFICANT ECONOMIC LOSS”

Section 167 of the Code allows a depreciation deduction “for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in a trade or business . . . or of property held for the production of income.” Neither the Code nor the Treasury Regulations impose a requirement that a taxpayer must suffer an economic loss in order to claim a depreciation deduction. Yet the Fifth Circuit has imposed this requirement in its decision in *Hibernia National Bank v. United States*. This faulty reasoning was...
first adopted by the Fifth Circuit in its decision in *Royal St. Louis v. United States*,\(^27\) a case involving the same taxpayer. The Fifth Circuit has the impression, based upon an erroneous interpretation of the Supreme Court’s decision in *Massey Motors, Inc. v. United States*,\(^28\) that the purpose of depreciation is to allow the taxpayer to recover an economic loss. According to the Fifth Circuit, because of this purpose, no deduction is allowable when the taxpayer will suffer no economic loss.\(^29\)

The purpose of depreciation, as expressed by the Supreme Court in *Massey Motors*, is to permit a taxpayer to recover, tax-free, the total cost to him of his capital assets.\(^30\) The Supreme Court stated in *Massey Motors* that depreciation is an accounting concept\(^31\) that simply provides for a meaningful allocation of the cost of an asset to the periods to which it contributes.\(^32\) The concept does not require that “economic” loss be demonstrated, and neither did the Supreme Court impose such a requirement in *Massey Motors*. The Supreme Court in *Massey Motors* pointed out that Congress specifically recognized the depreciation equation when it adopted the 1954 Code.\(^33\) The Court quoted from the accompanying House bill: “Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in a business. The annual deduction is computed by spreading the cost of the property over its estimated useful life.”\(^34\)

While the *Massey Motors* Court did make the statement that Congress intended, by the depreciation deduction, “not to make taxpayers a profit thereby, but merely to protect them from a loss,”\(^35\) it did not conclude that no deduction should be allowed if the taxpayer suffered no economic loss. This conclusion was formulated by the Tax Court in *Kem v. Commissioner*,\(^36\) and adopted by the Ninth Circuit upon appeal of the *Kem* decision.\(^37\) The Ninth Circuit in *Kem*

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\(^{27}\) 578 F.2d 1017 (5th Cir. 1978).

\(^{28}\) 364 U.S. 92 (1960).

\(^{29}\) See *Hibernia*, 740 F.2d 382, 386-87 (5th Cir. Sept. 1984).

\(^{30}\) 364 U.S. at 102-04.

\(^{31}\) Id. at 101.

\(^{32}\) Id. at 104. See the Supreme Court's discussion of the accounting concept of depreciation in *Massey Motors*, id. at 102.

\(^{33}\) Id. at 102.

\(^{34}\) Id. at 102-03 (quoting H.R. REP. NO. 1337, 83d Cong., 2d Sess. 22 (1954)).

\(^{35}\) Id. at 101.

\(^{36}\) 51 T.C. 455 (1968), aff'd, 432 F.2d 961 (9th Cir. 1970).

\(^{37}\) 432 F.2d 961 (9th Cir. 1970).
stated: "It is of course elementary that the purpose of depreciation deduction is to protect the taxpayer against loss, not to give him a profit. It follows, as the Tax Court properly said, that if no loss is suffered, no allowance for depreciation is reasonable . . . ." The Fifth Circuit adopted the reasoning of the Tax Court and the Ninth Circuit in *Kem* in its earlier decision in *Royal St. Louis, Inc. v. United States*, and disallowed the lessor a depreciation deduction on capital assets subject to a lease because the lessee was obligated to maintain the furnishings in first class condition. In its recent decision in *Hibernia National Bank v. United States*, the Fifth Circuit followed its earlier decision in *Royal St. Louis* and again disallowed the lessor a depreciation deduction. In *Hibernia National Bank*, the same lessor as in *Royal St. Louis* had amended the lease "so as to clarify the original intent of the parties." The amendments provided that the furnishings and equipment would be returned to the lessor in first class condition subject to normal wear and tear. The Fifth Circuit determined that the amendment did not "[alter] the economics of the parties' relationship" and that the lessor remained insulated from economic loss. While the Fifth Circuit did confine its holding to "the particular and somewhat, unique facts of the case, the provisions of the lease, the practice of the parties in carrying out the lease provisions, and the fact that the lease had once been interpreted by the Court," this was insufficient reason to deny the taxpayer in that case substantial depreciation deductions.

The Supreme Court in *Massey Motors* mentioned that depreciation deductions were not designed "to make taxpayers a profit" in the context of a concern that lessors of automobiles, like Massey Motors, could depreciate the entire cost of the automobiles, assigning the assets no salvage value, and within a short period of time, sell the sometimes completely depreciated assets at a substantial profit, the profit at that time being subject to capital gain treatment. *Massey Motors* was decided in 1960 before section 1245 was added to the Code. Because of section 1245 requirements, a taxpayer must now report the gain on the sale of depreciable property as ordinary income to the extent of depreciation deductions. While the Supreme Court in *Massey Motors*
sought to rectify the benefit the taxpayer received, before the advent of section 1245, of charging depreciation on capital assets against ordinary income and then reporting profit on the sale of such assets as capital gain, its solution was to require the lessor to measure salvage value on the leased automobiles at the resale value,\textsuperscript{44} not to disallow a depreciation deduction altogether. The Supreme Court stated in \textit{Massey Motors} that to carry no salvage value for an asset that can be sold at a substantial profit is not accurate accounting.\textsuperscript{45}

Because of its misinterpretation of the prior decision of the Supreme Court in \textit{Massey Motors}, the Fifth Circuit in \textit{Hibernia National Bank}\textsuperscript{46} has placed a harsh and unrealistic burden on the taxpayer. How is an “economic loss” to be demonstrated? The Fifth Circuit pointed to a provision in the regulations which states, \textit{inter alia}, that the determination of the amount of depreciation allowable “shall be determined upon the basis of conditions known to exist at the end of the period for which the return is being made.”\textsuperscript{47} This provision further provides that deductions for depreciation “shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property.”\textsuperscript{48} Salvage value and useful life are to be determined based upon conditions known to exist at the time the return is prepared. Then, as the regulations provide, changes in the amount of the depreciation deduction, as calculated at the time the return is prepared, are made “only where there is clear and convincing basis for a change.”\textsuperscript{49} The regulations do not provide that a taxpayer must demonstrate economic loss at the time of filing a return.

The Internal Revenue Service (IRS) undoubtedly has attempted to impose the requirement of an economic loss on property subject to a lease, because improvements made to leased property are not taxed to the lessor unless made in lieu of rent.\textsuperscript{50} In \textit{Hibernia National Bank}, the lessee was required to expend a minimum of $600,000 for repairs and replacement of the building, fixtures, furniture and equipment

\textsuperscript{44} 364 U.S. at 107.
\textsuperscript{45} \textit{Id.} at 101.
\textsuperscript{46} 740 F.2d 382 (5th Cir. Sept. 1984).
\textsuperscript{47} \textit{Id.} at 388; see Treas. Reg. § 1.167(b)-0 (1977).
\textsuperscript{48} Treas. Reg. § 1.167(b)-0 (1977). Salvage value is ignored under current § 168 which determines depreciation deductions for assets placed in service after 1980.
\textsuperscript{49} \textit{Id.}
\textsuperscript{50} See I.R.C. § 109 (1982).
during the lease period. The IRS would be concerned that the $600,000 would not be taxed to the lessor, yet the lessor would be entitled under section 167 of the Code to a depreciation deduction on the cost of the leased property. However, this problem should not be solved through a distortion of the concept of depreciation. If the requirement that a taxpayer demonstrate an "economic loss" is to be imposed upon a lessor, it must also be imposed on other taxpayers. Such a requirement would remove certainty from the tax law and, additionally, would be in conflict with section 167 of the Code.

III. UTILIZATION OF CORN PRODUCTS DOCTRINE BY A HOLDING COMPANY

The landmark Supreme Court case, *Corn Products Refining Co. v. Commissioner*, created an exception to the definition of a capital asset as set out in section 1221 of the Code. Even though a particular asset, such as a corporate security, is normally classified as a capital asset, it will not be so characterized if it was purchased for a business purpose as distinguished from an investment purpose. The so-called Corn Products doctrine requires that the broad Code definition of capital assets be narrowly applied with the exclusions from capital asset status being broadly interpreted. Although *Corn Products* converted an otherwise long-term capital gain on the sale of a futures contract to ordinary income and thus favored the government, application of the doctrine will favor a taxpayer when the sale is at a loss. Further, because the reporting of a long-term capital gain on the sale of a corporate security will seldom be questioned, inasmuch as the IRS would normally be unaware of a business motive in purchasing the security, the Commissioner's victory in *Corn Products* has been a hollow one. As a result, the IRS has attempted to limit application of the doctrine in cases in which taxpayers have claimed ordinary loss treatment on the sale of assets generally classified as capital assets.

The Fifth Circuit recently addressed the question whether *Corn Products* can be applied to a holding company in *Campbell Taggart, Inc. v. United States*. The Commissioner argued against its applica-

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51. 740 F.2d at 385.
tion contending that a pure holding or investment company cannot have a "business purpose" in purchasing corporate securities because the acquisition of stock and the collection of dividends can never constitute a "business." The taxpayer in *Campbell Taggart* had reported its loss on the sale of securities in a foreign corporation as ordinary loss, contending that the securities had been purchased for a business, rather than an investment, purpose.

The government argued in *Campbell Taggart* that corporate securities are ordinary assets under *Corn Products* only if purchased without an investment motive and as a necessary and integral act in the taxpayer's "business." The Fifth Circuit rejected this approach and determined that the test of *Corn Products* is whether the asset was acquired with a business purpose or with an investment purpose. It held that a finding that an acquisition was a "necessary and integral act" in the taxpayer's business is not a separate element of the test but rather one factor in determining the taxpayer's motive in purchasing the asset, whether business or investment. To ascertain the taxpayer's purposes, an objective evaluation must be made of all the circumstances surrounding the transaction. Relevant factors include the following: (1) taxpayer's statement of its subjective intent at the time of acquisition, (2) taxpayer's statements of its subjective intent at the time of disposition, (3) the needs of the particular business, (4) the length of time the asset was held, (5) the nature of taxpayer's other business and investment activities, and (6) the business and investment advantages that might reasonably be expected to flow from the acquisition or expenditures. The Fifth Circuit did stress that reliance on the taxpayer's purpose or motive was not intended to place ordinary or capital treatment at the whim of the taxpayer. The court pointed out that suggestions have been made that Congress solve this dilemma by requiring taxpayers to declare their purpose in holding stock at the time of acquisition.

The Fifth Circuit rejected the government's position that a hold-

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55. Id. at 447.
56. Id. at 446.
57. Id. at 447.
58. Id. at 458.
59. Id. at 459.
60. Id. at 458.
61. Id. (citations omitted).
62. Id.
63. Id.
ing company is not engaged in a "business" for tax purposes. 64 Re­
viewing the cases that have applied section 162 of the Code to permit 
holding companies to deduct certain expenditures as ordinary and 
necessary business expenses, 65 the Fifth Circuit concluded that a 
holding company is engaged in a "business for certain tax pur­
poses." 66 It noted that section 212 of the Code, which provides an 
individual a deduction for expenses of an investment activity as dis­
thinguished from a trade or business, does not apply to corpora­
tions because of the strong implication that investment activities of a 
corporation constitute a trade or business. 67 The Fifth Circuit ruled 
that a holding company, like any other taxpayer, is entitled to an op­
portunity to convince a factfinder that it has met the Corn Products 
test. 68

In answer to the government's contention that Campbell Taggart 
will greatly expand Corn Products, 69 the Fifth Circuit pointed out 
that the district court found that the holding company had a single 
motive in purchasing the stock; 70 thus, Campbell Taggart does not 
address the mixed-motive cases where the court must determine 
whether the investment motive was substantial. 71

IV. LIABILITY OF A PRIVATE FOUNDATION FOR EXCISE TAXES

Pursuant to the Tax Reform Act of 1969, 72 Congress enacted a 
series of excise taxes, sections 4940 to 4945 of the Code, to be imposed 
upon private foundations to reduce, if not to eliminate, the opportu­
nity for individuals to create tax-free organizations for the pursuit of 
their private purposes. 73 A literal interpretation of the language of 
these Code sections and the regulations pertaining thereto, can render

64. Id. at 451.
65. See, e.g., Allied Chemical Corp. v. United States, 305 F.2d 433, 437 (Ct. Cl. 1962) 
(holding company permitted to deduct fees expended to contest SEC plan to liquidate corpora­
tion in which holding company held stock); see also Alleghany Corp. v. Commissioner, 28 T.C. 298, 305 (1957) 
(holding company permitted to deduct expenses incurred in opposing reorgan­
ization plan of corporation in which holding company held stock).
67. Id. at 453.
68. Id. at 456.
69. Id. at 459.
70. Id.
harsh results for private foundations. The Fifth Circuit opted for such a literal interpretation of the Code in one of its recent decisions, *Gladney v. Commissioner*, 74 while rejecting such an approach to the regulations in another, *Zemurray Foundation v. United States*. 75

A. Taxable Expenditures Under Section 4945 of the Code

Section 4945 of the Code imposes an excise tax on amounts expended by a private foundation for other than specified charitable purposes. 76 In *Gladney v. Commissioner*, 77 the IRS assessed a penalty tax under this section in excess of $200,000, which exceeded the fair market value of the assets of a private foundation. 78 The foundation in *Gladney* was a trust created in 1905 by the provisions of a will for purposes of funding a home for elderly men. 79 The number of residents of the home substantially decreased in the 1950s and expenses of operation were causing the foundation financial difficulties. 80 Consequently, the residual heirs under the will sued in a Louisiana court in 1963, to terminate the trust and to distribute any remaining assets to the heirs. 81 The foundation was finally terminated by the Louisiana court in 1971. 82

Section 4945(d) of the Code lists four types of expenditures that are subject to the excise tax under that section. 83 None of these provisions applied to the foundation in *Gladney*. However, section

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74. 745 F.2d 955 (5th Cir. Nov. 1984), cert. denied, 106 S. Ct. 258 (1985).
75. 755 F.2d 404, 410 (5th Cir. Mar. 1985).
77. 745 F.2d 955 (5th Cir. Nov. 1984), cert. denied, 106 S. Ct. 258 (1985).
78. Id. at 959.
79. Id. at 957.
80. Id.
81. Id. at 958.
82. Id.
83. Section 4945(d) reads:

For purposes of this section, the term “taxable expenditure” means any amount paid or incurred by a private foundation—

(1) to carry on propaganda, or otherwise to attempt, to influence legislation within the meaning of subsection (e),

(2) except as provided in subsection (f), to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive,

(3) as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfied the requirements of subsection (g),

(4) as a grant to an organization (other than an organization described in paragraph (1), (2), or (3) of section 509(a)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h) or

(5) for any purpose other than one specified in section 170(c)(2)(B).
4945(d)(5) has a catch-all phrase, taxing expenditures "for any purpose other than one specified in section 170(c)(2)(B)." The IRS imposed the excise tax under this catch-all provision, contending that the foundation failed to comply with section 507 of the Code before it terminated; thus, the transfer of its assets to the heirs was not an expenditure specified in section 170(c)(2)(B). Section 507 requires that a private foundation must notify the IRS before terminating its status as a private foundation. However, failure to comply with section 507 triggers a termination tax prescribed by section 507(c); no reference is made to the imposition of a tax under section 4945. The tax imposed by section 507(c) is the lesser of the value of the net assets of the foundation or the "aggregate tax benefit" realized by the foundation and its substantial contributors. The "aggregate tax benefit" is the combined total of the income, estate, and gift taxes that the donors would have paid if the donations had been disallowed, plus all income taxes the foundation would have owed over the years. In Gladney, the foundation was created before federal estate, gift, or income taxes were imposed on individuals. Further, the foundation was terminated before it had any income that would have been taxed under the Tax Reform Act of 1969. Consequently, there would have been no tax benefits to the donors or the foundation and, thus, no tax under section 507(c). Further, while section 507 was added to the Code in 1969, regulations prescribing the manner of giving notice of termination were not proposed until April 1972 and were not adopted until December 1972. The foundation in Gladney was terminated in 1971. The IRS nonetheless imposed a penalty tax under section 4945(d)(5), alleging that expenditures were made for other than charitable purposes in that the assets of the foundation were distributed to the heirs before notification of termination had been given

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Justice Politz in his dissenting opinion in Gladney stated that he does not "glean from this language any congressional desire to protect the public fisc from intrusions occasioned by the distribution of trust assets to heirs of the testamentary settlor." 745 F.2d 955, 966 (5th Cir. Nov. 1984) (Politz, J., dissenting), cert. denied, 106 S. Ct. 258 (1985).

85. 745 F.2d at 958.
87. Id. § 507(c).
89. Private charitable foundations were not subjected to tax prior to the passage of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.
90. Treas. Reg. § 1.507-1 to -9 (1972); see 745 F.2d at 955, n.10.
to the IRS as required by section 507.91

The Tax Court ruled in favor of the taxpayers because there would have been no liability under section 507(c) and because the IRS had taken no public position under section 507(a) of the Code in the form of regulations to prescribe the time and manner in which an organization was to notify the IRS of its intention to terminate its private foundation status.92 The Fifth Circuit reversed the Tax Court, ruling that the failure of the IRS to promulgate regulations under section 507(a) did not relieve the foundation of its duty under the statutory notice requirement of section 507(a).93 The foundation did not fail to comply with manner of notice under regulations promulgated later; it failed to give any type of notice. The fact that it owed no tax under section 507(c) was deemed to be irrelevant because the court determined that imposition of the tax was not the sole purpose of the notice requirement, but rather that the notice requirement under section 507 "[w]as part of a larger statutory scheme."94

The dissent in Gladney pointed out that the tax law (the Tax Reform Act of 1969) was new at the time the foundation was terminated. While this did not excuse its failure to notify the IRS, it should not have caused such a harsh penalty as the forfeiture of the entire assets of the foundation, particularly in light of the fact that no section 507 taxes were applicable.95

B. Audit Tax Under Section 4940

In Zemurray Foundation v. United States,96 the Fifth Circuit was more lenient with the taxpayer and held a catch-all phrase in the regulations under section 4940 of the Code to be invalid.97 Consequently, the foundation in Zemurray was not subjected to an excise tax under section 4940 of the Code on the sale of its timber land. The Zemurray decision can be distinguished from the Gladney decision in the limited context that a regulation (rather than a Code provision as in Gladney), was at issue in Zemurray, the court in Zemurray deem-

91. 745 F.2d at 958-59.
93. 745 F.2d at 961.
94. Id.
95. Id. at 965.
96. 755 F.2d 404 (5th Cir. Mar. 1985).
97. Id. at 413. However, in an earlier decision, Zemurray v. United States, 687 F.2d 97 (5th Cir. 1982) (Zemurray I), the Fifth Circuit upheld the regulation.
ing the regulation to be an enlargement of a Code provision, section 4940(c)(4)(A).98

In Zemurray, the foundation acquired a tract of timber land which it sold before it received any income from the property. The IRS assessed a tax in the amount of $112,317, based upon its determination that the sale was subject to the excise tax imposed by section 4940 of the Code,99 which taxes the net investment income of private foundations. Net investment income is defined as “gross investment income” plus “capital gain net income” minus allowable deductions.100 Capital gain income is defined to include “gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties.”101 The regulations under section 4940 provide that property held “for investment purposes” is subject to tax under section 4940.102 Property is treated as held for investment purposes if it is a type which generally produces: (1) interest, (2) dividends, (3) rents, (4) royalties, or (5) capital gains through appreciation.103 The timber land in Zemurray had never been used to produce income of the four categories listed in the regulations; thus, the foundation contended that the sale was not subject to tax under section 4940. The IRS, on the other hand, contended that the sale was subject to the tax because the property was of a type that “generally” produced investment income. The district court agreed with the foundation that it should not be subject to the tax in that it never “actually used” the property for investment purposes.104 The Fifth Circuit in the first Zemurray appeal, Zemurray I, reversed and remanded the case for a determination of whether the timber land was "susceptible for use" to produce investment income, holding that the

98. 755 F.2d at 414; see Treas. Reg. § 53.4940-1(f)(1). The regulation provides: [P]roperty shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stocks, bonds, mineral interests, mortgages, and securities). Under this subparagraph, gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded.

99. 755 F.2d at 406-07.


101. Id. § 4940(c)(4)(A).


103. Id.

use of the phrase "generally used" in the regulation was valid. Upon remand, the district court again held for the foundation, finding that the property was not susceptible for use to produce investment income in that it was not economically prudent to rent the timber land. On the second appeal, Zemurray II, the Fifth Circuit held that the finding of the trial court that the timber land was not susceptible for use to produce investment income, was not clearly erroneous.

The Fifth Circuit in Zemurray II also held that the fifth category of the regulation that would impose a tax on capital gains from appreciation does not provide a valid independent basis for taxation under section 4940. According to the court, if the fifth category were an independent category of taxable property, the sale of a jade figurine or an ornate silver chalice, as examples, would produce a tax under section 4940. While the IRS argued that Congress intended to tax all gains resulting from the disposition of investment-type assets used by a charitable foundation for noncharitable purposes, the Fifth Circuit refused to apply such a far-reaching interpretation of section 4940. The court noted that when Congress wished to draw a distinction between charitable and noncharitable assets, it did so explicitly. Further, the Senate version of section 4940 sought to impose an annual tax on the noncharitable assets of a foundation. However, Congress adopted the House version which eliminated this distinction. Thus, the Fifth Circuit concluded that Congress did not intend to impose a tax on the disposition of all noncharitable assets of the foundation and held that the fifth category of property in the regulation was invalid in that it is broader than the four categories of section 4940(c)(4)(A).

105. See 687 F.2d 97, 102 (5th Cir. 1982).
108. Id. at 413.
109. Id.
110. Id.; see, e.g., I.R.C. § 4942(e)(1)(A) (1982) (minimum investment return for any private foundation, used in computing tax on undistributed income of a private foundation, is based upon the fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out foundation's exempt purpose).
113. Zemurray II, 755 F.2d at 413.
The taxpayer's victory in Zemurray II is limited. The Fifth Circuit did not hold the fifth category of property listed in regulation 53-4940-1(f)(1) invalid in its entirety—it held it invalid only as it would provide an independent basis for taxation under section 4940. The regulation was held to be valid to the extent that it reaches property of a type that generally produces interest, dividends, rents, or royalties, but which is being held, in the particular instance, for capital gains through appreciation. In this regard, the regulation still enlarges upon section 4940(c)(4)(A) for that section provides for a tax only on "the sale or other disposition of property used for the production of [income]."

In the recent case of Greenacre Foundation v. United States, the Federal Circuit Court of Appeals held a foundation liable for the tax under section 4940 on the sale of securities that were sold within a few days after receipt. Dividends were never received on the securities; however, the court determined that because the securities "generally produce[s]" dividends, gain on the sale would be taxed. The Federal Circuit held that it was not unreasonable for the Treasury to adopt an interpretation of the term "property used" in section 4940 to include property "generally used." The court noted that if "used" is limited to "actually used," gain on the sale of a security that produced one dividend during the short period it was held, would be taxed, while one that produced no dividends would not. This, according to the court, would be an "eccentric result." The Treasury's interpretation, according to the court, provides ease of enforcement in that one does not have to consider the individual taxpayer's particular circumstances. This case differs from Zemurray in that the securities "generally" produced dividend income, whereas the district court in Zemurray found, upon remand, that the timber land was not "susceptible" for use as rental property; consequently, it was not property that "generally" produced investment income.

The Fifth Circuit's approach in Zemurray II, which invalidated a Treasury regulation in the limited instance wherein it would include an independent basis of taxation outside that enumerated in the Code.

114. Id. at 414.
116. 762 F.2d 965 (Fed. Cir. 1985).
117. Id. at 968.
118. Id.
119. Id. at 967.
120. Id. at 968.
is difficult to reconcile with its harsh decision in *Gladney*. The Tax Reform Act of 1969, which first imposed taxes on private foundations, was designed to curb certain abuses by private foundations and to assure that "investments of these organizations are not jeopardized by financial speculation." However, as the Federal Circuit pointed out in *Greenacre*, while these purposes apply to the penalty taxes under sections 4941 to 4945 of the Code, the purpose of the section 4940(a) tax was to "impose a type of user fee or tax to help pay for the administration of private foundations." Section 4940(a) imposes not a penalty tax but simply an excise tax on net investment income, imposed regardless of whether the foundation has engaged in prohibited activities. Thus, the court in *Greenacre* saw no problem in imposing a tax under section 4940. However, the Fifth Circuit determined that *Zemurray* was not liable for the section 4940(a) user tax; on the other hand, it found that *Gladney* was subject to the penalty tax under section 4945 in an extremely strained version of that Code section.

V. Loan or Contribution to Capital

Shareholders of a corporation generally consider the advantages of characterizing contributions to the capital of their corporation as debt rather than as stock. Interest on debt is deductible by the corporation, whereas dividend payments are not. Further, the shareholders are not taxed on principal repayments unless the repayments exceed the taxpayer's basis in the debt. On the other hand, so long as a corporation has earnings and profits, an investment in stock cannot be withdrawn tax-free. Any withdrawals are taxable dividends to the extent of the shareholder's pro rata share of earnings and profits of the distributing corporation. The IRS will often contend that debt to a shareholder is really an equity interest, thus denying to the shareholders the tax advantages of debt financing. When a debt

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123. 762 F.2d at 969.
125. See I.R.C. § 316(a) (1982).
126. Id.
127. See, e.g., John Kelly Co. v. Commissioner, 326 U.S. 521, 530 (1946) (payments made under certain corporate obligations found to be dividends); Fin Hay Realty Co. v. United States, 398 F.2d 694, 695 (3d Cir. 1968) (two stockholders of corporation advanced amounts to corporation to enable it to purchase apartment buildings).
instrument has too many features of stock, it is treated as a form of stock, with any principal or interest payments being classified as dividends.\textsuperscript{128}

In resolving the question of whether monies advanced by a shareholder to a corporation constitute a loan or a contribution to capital, courts generally go beyond the form and look into the substance of the particular transaction. Courts have developed a set of factors to which they look to resolve the debt-equity controversies.\textsuperscript{129} The Fifth Circuit listed the set of factors it would use in \textit{Texas Farm Bureau v. United States}, as follows:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.\textsuperscript{130}

Application of the debt-equity factors was held to be the responsibility of the courts; thus, characterization of an advance as either debt or contribution to capital is primarily a question of law, according to the Fifth Circuit.\textsuperscript{131} There is one exception to the debt-capital contribution determination being a matter of law. According to the Fifth Circuit this exception arises when a court must rely on the parties' subjective intent, factor number seven.\textsuperscript{132}

The Fifth Circuit applied the factors set out in \textit{Texas Farm Bureau} to disallow a deduction for advances made to a corporation formed to market computer programs in \textit{Piggy Bank Stations, Inc. v. Commissioner}.\textsuperscript{133} The Fifth Circuit noted that the corporation was severely undercapitalized from its beginning and that the taxpayer

\textsuperscript{128} See I.R.C. § 385 (1982).
\textsuperscript{129} See, e.g., \textit{Texas Farm Bureau v. United States}, 725 F.2d 307, 311 (5th Cir. 1984), \textit{cert. denied}, 105 S. Ct. 778 (1985) (advances made by taxpayer to affiliate corporation).
\textsuperscript{130} \textit{Id.} at 311-12.
\textsuperscript{131} \textit{Id.} at 312.
\textsuperscript{132} \textit{Id.} at 312.
\textsuperscript{133} 755 F.2d 450 (5th Cir. Mar. 1985).
making the advances could have expected repayment only if the corporation became a successful business enterprise.\textsuperscript{134} The court noted that the corporation had been unable to obtain additional financing from third parties. While some of the advances were evidenced by demand notes, the notes were not issued contemporaneously with the advances but rather at irregular intervals to memorialize the aggregate total advanced at various times. Further, although the notes provided for an interest rate of ten percent, no interest was collected. The court concluded that the overwhelming evidence suggested that the advances were capital contributions.\textsuperscript{135}

Shareholder loans to a corporation having a fixed maturity date and providing the shareholder with the right to enforce payment of both principal and interest are often nonetheless characterized by the courts as equity when much of the debt is used to acquire capital assets of the corporation.\textsuperscript{136}

\textbf{VI. ORDER OF LIMITATIONS ON TAX DEDUCTIONS FOR PERCENTAGE DEPLETION AND DIVIDENDS RECEIVED DEDUCTION}

The Fifth Circuit was faced with an interesting query in \textit{LaStarmco, Inc. v. Commissioner,}\textsuperscript{137} regarding the ordering of deductions subject to limitations based on taxable income. The taxpayer had taxable income, before a deduction for percentage depletion and for dividends received, in the amount of $470,980.\textsuperscript{138} The percentage depletion deduction, before application of the limitation under section 613A(d)(1) of the Code that provides the deduction may not exceed sixty-five percent of taxable income, was $58,049. The taxpayer's dividends received deduction, before the limitation under section 246(b)(1) to eighty-five percent of taxable income, was $415,992.\textsuperscript{139} Neither limitation, section 613A or section 246(b)(2), takes into account the existence of the other. The IRS computed taxpayer's taxable income to be $19,246 ($54,988 ($470,980, taxable income before either deduction, less $415,992, dividends received deduction) less

\begin{itemize}
  \item \textsuperscript{134} \textit{Id.} at 455.
  \item \textsuperscript{135} \textit{Id.}
  \item \textsuperscript{136} \textit{See, e.g., Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 722 (5th Cir.), cert. denied, 409 U.S. 1076 (1972).}
  \item \textsuperscript{137} 737 F.2d 1440 (5th Cir. Aug. 1984).
  \item \textsuperscript{138} \textit{Id.} at 1440.
  \item \textsuperscript{139} \textit{Id.}
\end{itemize}
The taxpayer deducted percentage depletion before the dividends received deduction with the result that the percentage depletion deduction of $58,049 was not reduced by the limitation under section 613A(d)(1). Taxpayer then deducted the full $415,992 dividends deduction because section 172(d)(5) of the Code provides that a net operating loss is computed without regard to the limitation on dividends received, and section 246(b)(2) provides that the eighty-five percent of taxable income limitation on the dividends received deduction does not apply if the taxpayer has a net operating loss for the year (as determined under section 172). Taxpayer's calculations produced a net operating loss of $3,061 ($470,980 (taxable income before either deduction) less $58,049 (percentage depletion deduction) less $415,992 (dividends received deduction)). Thus, there was a difference in taxable income of $22,307 ($19,246, taxable income as computed by the IRS, plus $3061, net operating loss as computed by the taxpayer) depending upon which interpretation was correct.

The Tax Court had ruled for the taxpayer, determining that deductions are generally taken before the dividends received deduction. The Tax Court pointed out that the charitable contributions deduction for corporations is limited by section 172(d)(5) to a percentage of taxable income but computed without regard to the dividends received deduction. Section 613A was added to the Code later, in 1975, without addressing the present issue, but not implying that the limitation should be applied after the dividends received deduction.

The Fifth Circuit determined that the Tax Court committed no error in finding that the taxpayer's method of calculating the net operating loss—nonapplication of the percentage limitation upon the dividends received deduction—was more in accord with the intent of Congress.

140. Id. at 1442-43.
141. Id. at 1443.
142. Id.
144. 79 T.C. at 818-20.
145. Id. at 822-24.
146. 737 F.2d at 1444.
VII. Tax Procedure

A. Third-Party Summons for Taxpayer Records

Section 7609 of the Code permits the IRS to issue a summons to any third party recordkeeper requiring the production of documents in the third party’s possession relating to a specific taxpayer whose financial activities are being audited. Notice of the summons must be given to the taxpayer, who has the right to intervene and begin a proceeding to quash the summons, or if a proceeding to enforce the summons has been commenced, to intervene in that proceeding.\(^{147}\) Previously the burden was on the IRS to commence a summons enforcement proceeding. The taxpayer could automatically stay a third party’s compliance with the summons by instructing the third party in writing not to comply with the summons. Once the third party received such a notice from the taxpayer, the IRS could not proceed without a court order.\(^{148}\) The Code was amended in 1982;\(^{149}\) now the burden to commence litigation with respect to the validity of a third-party summons is on the taxpayer who may institute a proceeding to quash.\(^{150}\)

Section 7609(h) provides that the United States district court for the district within which the person to be summoned resides or is found “shall have jurisdiction to hear and determine any proceeding” to enforce a summons. The Fifth Circuit construed the jurisdictional limitations of this provision in *Masat v. United States*\(^{151}\) and *Deal v. United States*.\(^{152}\) Taxpayers in *Masat* and *Deal* were both residents of Texas. The IRS summoned records of third parties residing in California in *Masat*,\(^{153}\) and Georgia in *Deal*.\(^{154}\) In both cases, the taxpayers filed a petition in Texas to quash the third-party summonses. The Fifth Circuit noted in both cases that jurisdiction is exclusively in the district in which the third-party recordkeepers reside; section 7609(h) is a jurisdictional statute not a special venue provision.\(^{155}\) Conse-

\(^{147}\) See I.R.C. § 7609(b)(2) (1982).
\(^{150}\) 745 F.2d 985 (5th Cir. Nov. 1985).
\(^{151}\) 745 F.2d 985 (5th Cir. Nov. 1985).
\(^{152}\) 759 F.2d 442 (5th Cir. May 1985).
\(^{153}\) 745 F.2d at 986.
\(^{154}\) 759 F.2d at 443.
\(^{155}\) Id. at 444; 745 F.2d at 987.
sequently, a suit commenced in a Texas district court was properly dismissed in both cases.

B. Standard of Review for Enforcement of a Summons

In *United States v. Texas Heart Institute*,\(^\text{156}\) the Fifth Circuit reviewed the four requirements for enforcement of an IRS summons as set out in *United States v. Powell*.\(^\text{157}\) Those requirements are: (1) the IRS must demonstrate that the investigation will be conducted pursuant to a legitimate purpose; (2) the inquiry must be relevant to the purpose; (3) the information sought by the IRS must not already be within its possession; and (4) the administrative steps required by the Code must have been followed.\(^\text{158}\) Parties resisting the summonses must demonstrate that the IRS failed to meet the *Powell* requirements or that enforcement would represent an abuse of the court’s process.\(^\text{159}\)

In *Texas Heart Institute*, the taxpayer argued that the IRS had no legitimate purpose in its investigation because the real purpose was harassment.\(^\text{160}\) The taxpayer had refused to agree to a second extension of the statute of limitations under section 6501 regarding period of time of the IRS to assess a tax deficiency; as a result, the IRS transferred the case to the Criminal Investigation Division. The transfer avoided the expiration of the statute of limitations. The Fifth Circuit noted that the real issue was not whether the taxpayer perceived actions of an IRS agent as threats, but rather whether there was a legitimate purpose of the investigation.\(^\text{161}\) The Fifth Circuit held that the district court’s finding that there were some irregularities in the taxpayer’s accounts was not clearly erroneous to demonstrate a legitimate purpose for the investigation.\(^\text{162}\)

The taxpayer in *Texas Heart Institute* alleged improper disclosures of taxpayer return information in violation of section 7213 of the Code as further evidence that the IRS lacked a legitimate purpose for its investigation.\(^\text{163}\) The IRS included in its requests to third parties for certain information, a statement that the taxpayer was subject

\(^{156}\) 755 F.2d 469 (5th Cir. Mar. 1985).


\(^{158}\) *Id.* at 57-58.

\(^{159}\) *Id.* at 58.

\(^{160}\) 755 F.2d at 478-79.

\(^{161}\) *Id.* at 479.

\(^{162}\) *Id.*

\(^{163}\) *Id.* at 479.
to a criminal investigation. The IRS obtained from these third parties, the names of patients of the taxpayer and mailed form letters to the patients stating that the taxpayer was under criminal investigation. Each patient was asked to provide dates and amounts of payments made to the taxpayer for medical services.\textsuperscript{164} The Fifth Circuit disagreed that these allegations demonstrated that the IRS investigation was not being conducted pursuant to a legitimate purpose.\textsuperscript{165} The Fifth Circuit declined to determine whether there were improper disclosures, stating that that was a separate issue in the taxpayer’s civil action against the IRS.\textsuperscript{166} The focus of the court was on legitimate purpose so as to bar enforcement of the summons.\textsuperscript{167}

The Supreme Court addressed the meaning of the \textit{Powell} criterion of relevancy in \textit{United States v. Arthur Young & Co.}\textsuperscript{168} In this case, the Supreme Court noted that an IRS summons is not to be judged by the relevance standards used in deciding whether to admit evidence in federal court.\textsuperscript{169} Section 7602 of the Code authorizes the Secretary of the Treasury to summon and examine any records that “may be” relevant to a particular tax inquiry. The Supreme Court stated that the language “may be” reflects Congress’ express intention to permit the IRS to obtain items of even potential relevance to an ongoing investigation.\textsuperscript{170} The correct test for relevancy is whether the summons seeks information which might throw light upon the correctness of the taxpayer’s return.\textsuperscript{171}

In \textit{Texas Heart Institute}, the Fifth Circuit noted that once the IRS has denied possession of the summoned information, by affidavit and testimony, the burden of showing actual possession of the information by the IRS (the third requirement under \textit{Powell}) shifts to the taxpayer.\textsuperscript{172} A mere showing by the taxpayer that the IRS has previously examined the taxpayer’s own records is not sufficient to show either that the IRS possesses that information or that it possesses in-

\textsuperscript{164} Id. at 480.
\textsuperscript{165} Id.
\textsuperscript{166} Id.
\textsuperscript{167} Id.
\textsuperscript{168} 104 S. Ct. 1495 (1984).
\textsuperscript{169} Id. at 1501; see FED. R. EVID. 401.
\textsuperscript{170} \textit{Arthur Young & Co.}, 104 S. Ct. at 1500-01.
\textsuperscript{171} Id. at 1501. The Fifth Circuit in \textit{Texas Heart Inst.} did not elaborate on whether the Supreme Court in \textit{Arthur Young & Co.} expanded the standard by its statement that records that “illuminate any aspect of the return” are highly relevant to legitimate an IRS inquiry.
\textsuperscript{172} 755 F.2d at 476.
formation in the custody of parties other than the taxpayer.  

The administrative procedures set out in section 7609(a) of the Code provide that if a summons is served on a third-party recordkeeper and the summons requires the production of any portion of records made or kept of the business transactions or affairs of any person, other than the person summoned, who is identified in the description of the records contained in the summons, the person so identified must be given notice of the summons no later than the twenty-third day before the day stated in the summons for the examination of the requested records. The notice must contain an explanation of the right of the taxpayer to bring a proceeding to quash the summons and must either be served on the taxpayer or mailed by certified or registered mail to the last known address of the taxpayer. In the absence of a last known address, the notice may be left with the person summoned. The taxpayer in Texas Heart Institute alleged a failure to receive formal notice of the third-party summonses; thus, taxpayer contended that the IRS failed to follow the administrative procedures prescribed by section 7609(a), the fourth requirement of Powell. The Fifth Circuit construed the administrative steps to be less mechanistic than the taxpayer contended. It noted that because the taxpayer could demonstrate no prejudice from lack of formal notice, any alleged failure to give notice was harmless.  

The district court in Texas Heart Institute refused to enforce the summonses because it found an abuse of process; however, the Fifth Circuit concluded the district court's finding on this issue was clearly erroneous. The Fifth Circuit acknowledged that disclosure to taxpayer's patients that taxpayer was under criminal investigation by the IRS could be unlawful under section 7213 of the Code, and that if it was unlawful, it would be an abuse of the process to permit enforcement of the summonses when the IRS conceded it would continue to disclose such information. As a result, the Fifth Circuit remanded the

173. Id. at 477.  
175. Id. § 7609(a)(2).  
176. 755 F.2d at 473.  
177. Id. at 478.  
178. Id. at 482.  
179. Id. The IRS alleged that the information may be disclosed pursuant to § 6103(k)(6) of the Code in that such disclosures were necessary to obtain information not otherwise readily available, i.e., evidence of discrepancies between actual payments made by taxpayer's patients and taxpayer's records. Id. at 480.
case for a determination by the district court whether the described information fell within section 7213 of the Code, and if so, whether the IRS was authorized to disclose the information under section 6103(k)(6). The Fifth Circuit stated that an abuse of process would have occurred only if the district court concluded that disclosures by the IRS were not authorized. Nonetheless, even if past disclosure was improper, the Fifth Circuit ruled that the district court had discretion to condition enforcement of the summonses by requiring the IRS to desist from further unlawful disclosures.

In *Hodges, Grant & Kauffmann v. United States*, the IRS issued a summons to the taxpayer’s accountant to produce records pertaining to the taxpayer’s business. The accountant and the taxpayer’s law firm, which had hired him, resisted production. While the taxpayer appeared at the proceedings, he refrained from intervening presumably to prevent tolling of the statute of limitations on assessment of any tax deficiency. However, on appeal to the Fifth Circuit, the taxpayer sought to intervene as a party to the proceeding. The IRS contended that section 7609(b) only permits the taxpayer to intervene in actions in the district court. The Fifth Circuit agreed with the IRS that a taxpayer is precluded from awaiting “the outcome of the summons enforcement proceeding in the district court” and then intervening only in the appeals court should he or she be dissatisfied with the outcome. In addition, the court pointed out that issues not raised in the district court could not be raised for the first time on appeal. The Fifth Circuit noted that there were no unusual circumstances that would cause the court to permit taxpayer’s late interven-

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180. 755 F.2d at 482.
181. Id.
182. Id.
183. 762 F.2d 1299 (5th Cir. June 1985).
184. Id. at 1300.
185. Id. If a taxpayer intervenes in a proceeding to quash a summons, the running of the statute of limitations for the collection or assessment of any tax liability is suspended for the period during which the proceeding is pending. See I.R.C. § 7609(e) (1982).
186. Section 7609(b) provides that a person entitled to notice of a summons issued under § 7609(a) has the right “to intervene in any proceeding with respect to the enforcement of such summons under section 7604.” I.R.C. § 7609(b)(1) (1982). Section 7604 refers to a proceeding in the district court. Section 7609(h)(1) states that the United States district court for the district within which the person to be summoned resides or is found has jurisdiction to hear and determine any proceeding under § 7609. The section further provides that “an order denying the petition shall be deemed a final order which may be appealed.” Id. § 7609(h)(1).
187. 762 F.2d at 1301-02.
188. Id. at 1302.
Because taxpayer in Hodges "demonstrated calculated disregard of the proper procedure for a taxpayer to follow to participate in a procedure to quash an IRS summons," the court ruled that the taxpayer could not "belatedly change his strategy and intervene" in the appellate proceeding.\(^{190}\)

C. Enforcing a Tax Lien Against Property Transferred by Taxpayer

The Fifth Circuit in *United States v. Chapman*\(^{191}\) recognized that if a taxpayer has a property right under state law, that interest is subject to a government tax lien. If a taxpayer has transferred property in fraud of present and future creditors under applicable state statutes, the government may enforce a tax lien against the transferred property even though liability to the government had not matured into a debt at the time of the transfer.\(^{192}\) The Fifth Circuit applied Texas statutes as to fraudulent conveyances in *Chapman*, to uphold a finding of the district court that taxpayer had conveyed his residence to his daughter in fraud of the United States and that taxpayer's wife was not entitled to recognition of her homestead interest in the property.\(^{193}\) The Fifth Circuit noted that, while taxpayer and his wife still occupied the property transferred to their daughter, they occupied it as renters from their daughter. The court expressed doubt that Texas law would support a claim of a homestead right in a grantor who fraudulently conveyed property to another, since the latter would hold title to the property against all except the defrauded creditor.\(^{194}\)

D. Tax Fraud Prosecution

Section 7201 of the Code imposes criminal sanctions upon "any person who willfully attempts in any manner to evade or defeat" a

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189. *Id.* at 1303.
190. *Id.*
191. 756 F.2d 1237 (5th Cir. Apr. 1985).
192. *Id.* at 1240-41. As a general rule, a person who was not a creditor at the time of the transfer is not protected by statutes regarding fraudulent conveyances. However, a transfer is void as to a subsequent creditor if the transfer was made with a fraudulent intent at the time of the transfer to evade future liabilities to a subsequent creditor. *See* Hollins v. Rapid Transit Lines, Inc., 440 S.W.2d 57 (Tex. 1969), *cited in Chapman*, 756 F.2d 1237, 1241 (5th Cir. Apr. 1985); Hartman v. Hartman, 135 Tex. 596, 597, 138 S.W.2d 802, 803 (1940).
193. 756 F.2d at 1243. The taxpayer contended that because taxpayer's wife was not liable for the taxes in question, she was entitled to recognition of her homestead interest in the property. *Id.* (citing United States v. Rodgers, 461 U.S. 677, (1983)).
194. 756 F.2d at 1243.
federal tax. To establish a violation of section 7201, the government has the burden of proving beyond a reasonable doubt that the defendant willfully attempted to evade payment of taxes that were owed.

Where a taxpayer's records are inadequate to determine income tax liability, the government has utilized the net worth method of determining income in criminal tax prosecutions. Under this method, the government must establish the taxpayer's total value of his or her assets at the beginning of a given period and compare that value with the value of taxpayer's asset at the end of the period. The government must take into account cash on hand at the beginning of the period as well as increases in net worth that represent gifts, inheritances, loans, and other untaxable receipts. Nondeductible expenditures such as living expenses are added back into the net worth figure. With these adjustments, the government can prove that any unexplained increase in net worth represents unreported income.

To establish a prima facie showing of tax evasion using the net worth method, the government must establish with "reasonable certainty" an opening net worth balance. The Fifth Circuit found that the government met its burden in United States v. Terrell, through a source and application of funds analysis. The taxpayer's tax returns for the previous nine years were examined, and gross receipts indicated on the returns were entered as part of the source of funds analysis. Added to those figures were any other sources identified by the taxpayer or other witnesses. The government's analysis indicated that taxpayer had expended nearly $230,000 more than his total accumulated funds for the nine-year period. In addition, to have arrived at the taxpayer's estimation of cash on hand at the beginning of the period, the government showed that taxpayer would have had to accu-

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197. Id. at 1144.
198. Id.
199. Use of the net worth method was approved in Holland v. United States, 348 U.S. 121 (1954), but the Supreme Court noted in that case that an innocent individual with poorly kept records would not always be in a position to explain discrepancies in his or her net worth. Id. at 128. Consequently, the investigation techniques and figures are subject to close scrutiny. Id. at 129.
200. Id. at 132.
201. 754 F.2d 1139 (5th Cir. Feb. 1985).
202. Id. at 1147.
mulate an additional $400,000. The Fifth Circuit found no error in the use of the source and application of funds analysis to conclude that taxpayer had no cash on hand at the beginning of the indictment period.

Taxpayer in *Terrell* was a minister; he challenged the trial court's instruction to the jury that all amounts received by a minister were taxable and the court's refusal to instruct the jury on the elements of a nontaxable gift. The Fifth Circuit agreed with the district court that voluntary contributions and money given to a minister for religious purposes used by him for his personal benefits are taxable income.

In *United States v. Tafoya*, the Fifth Circuit ruled that evidence of a defendant's unindicted criminal behavior may be admissible in a criminal prosecution for tax evasion under the following circumstances: (1) if it is not offered to prove defendant's bad character, (2) if the evidence is probative of a material fact and therefore relevant, and (3) if the probative value of the evidence is not outweighed by the likelihood of unfair prejudice. While the district court in *Tafoya* initially refused to admit evidence regarding the defendant's assassination attempts, including shooting a Libyan residing in Colorado, firebombing a home in Canada, and obtaining poison in London for the purpose of killing an unknown person, it continually modified its ruling and accepted such evidence for the purpose of establishing that the defendant worked for various persons and received payments from them that were taxable income. The district court did, however, instruct the jury that the defendant was not on trial for any offense other than income tax evasion. The Fifth Circuit found no reversible error in the district court's admittance of evidence of defendant's assassination efforts, stating that it is not likely a person would receive only expenses, loans, or gifts for three attempted killings. The prosecutor had to show the jury that the defendant did

203. *Id.*
204. *Id.*
205. *Id.* at 1148.
206. *Id.* at 1149.
207. 757 F.2d 1522 (5th Cir. Apr. 1985).
209. 757 F.2d at 1525-26.
210. *Id.* at 1526.
something to earn the income he allegedly failed to report.\textsuperscript{211} While the court noted that the assassination evidence had “an obvious capacity to prejudice” the defendant unfairly, it did not find an abuse of discretion on the part of the district court in its conclusion that the probative value of the evidence outweighed the potential for unfair prejudice.\textsuperscript{212} The Fifth Circuit did, however, admonish the prosecutor for its efforts to repeatedly introduce potentially prejudicial details of the defendant’s assassination efforts. The court warned that tax cases are not to be transformed into trials for other crimes and that too much emphasis on the illegal source of the income or “dwelling on lurid details” can cause a reversal of a defendant’s conviction.\textsuperscript{213}

The Fifth Circuit, in \textit{Toussaint v. Commissioner},\textsuperscript{214} held that the government may discharge its burden of proving an intent to evade federal taxes, by producing circumstantial evidence.\textsuperscript{215} In \textit{Toussaint}, the defendant claimed a casualty loss tax deduction in the amount of $190,000 for an alleged theft of a Picasso painting. The Tax Court had found the defendant’s testimony regarding the painting to be “totally noncredible.”\textsuperscript{216} While the court noted that citing the “infirmities” of defendant’s account of the facts could appear to place the burden of proof upon the defendant, nonetheless the defendant’s failure to convince the trial court that he owned such a painting, a failure forced upon him by the government’s cross-examination and evidence, constituted the government’s success in discharging its burden.\textsuperscript{217} The Fifth Circuit noted the lack of credibility, the inconsistencies, and the evasiveness in the defendant’s testimony as factors in determining that the government had discharged its burden.\textsuperscript{218}

A showing that a defendant was aware that he was causing his

\textsuperscript{211} Id. at 1527.
\textsuperscript{212} Id.
\textsuperscript{213} Id. at 1528.
\textsuperscript{214} 743 F.2d 309 (5th Cir. Oct. 1984).
\textsuperscript{215} Id. at 312. The burden of proof requires clear and convincing evidence. \textit{Id.}; see also Marsellus v. Commissioner, 544 F.2d 883, 885 (5th Cir. 1977) (recognizing role that circumstantial evidence must play in determining intent where taxpayer placed all income in noninterest-bearing checking accounts in effort to avoid payment of taxes and detection); Stoltzfus v. United States, 398 F.2d 1002, 1005 (3d Cir. 1968) (requirement placed on government to show convincing evidence of intent may be met by circumstantial evidence where taxpayer’s claim for refund of fraud penalty levied in part due to his failure to file income tax returns for period 1943-1958).
\textsuperscript{216} 743 F.2d at 311.
\textsuperscript{217} Id. at 313.
\textsuperscript{218} Id. at 311.
taxable income to be underreported is sufficient evidence of an intent to make a material false statement on a tax return in violation of section 7206 of the Code, according to the Fifth Circuit in United States v. Barrilleaux.\textsuperscript{219} Having two bank accounts and reporting only one account to a taxpayer's bookkeeper is sufficient to support a finding that a taxpayer was aware his income would be underreported on his return.\textsuperscript{220}

Repeatedly claiming deductions for personal, nonbusiness expenditures can be sufficient evidence to establish that a taxpayer willfully and knowingly filed a false income tax return, according to the Fifth Circuit in United States v. Garcia.\textsuperscript{221} Taxpayer, in Garcia, had argued that the court's instruction to the jury was incomplete because it did not state that the word "willfully" required that a taxpayer have knowledge of the particular law he or she allegedly violated.\textsuperscript{222} The Fifth Circuit stated that a violation of the tax laws as a protest can be willful conduct and is no defense to a charge of income tax evasion.\textsuperscript{223}

\section*{VIII. Tax Protestors}

The Fifth Circuit was faced with a number of tax protestor cases during the current survey period. In the first of these, Crain v. Commissioner,\textsuperscript{224} the Fifth Circuit stated that it was not "obliged to suffer in silence the filing of baseless, insupportable appeals presenting no colorable claims of error and designed only to delay, obstruct, or incapacitate the operations of the courts or any other governmental authority."\textsuperscript{225} The Crain appeal was based on a challenge to the constitutional authority of the Tax Court and the jurisdiction of the IRS to levy taxes on the petitioner's income. The Fifth Circuit awarded the government twice the cost of the appeal and a damage award of $2000, designating the appeal as a frivolous proceeding under section 6673 of the Code.\textsuperscript{226} The Fifth Circuit made short shrift of the taxpayer's argument that the "Internal Revenue Service, Incorporated" lacked authority to exercise the judicial power of the United States, stating that it perceived no need to refute the tax-

\textsuperscript{219} 746 F.2d 254, 256 (5th Cir. Oct. 1984).
\textsuperscript{220} Id. at 256.
\textsuperscript{221} 762 F.2d 1222 (5th Cir. June 1985).
\textsuperscript{222} Id. at 1224.
\textsuperscript{223} Id. at 1224-25.
\textsuperscript{224} 737 F.2d 1417 (5th Cir. Aug. 1984).
\textsuperscript{225} Id. at 1418.
\textsuperscript{226} Id.
payer's arguments with somber reasoning because to do so "might suggest that these arguments have some colorable merit."\textsuperscript{227}

In spite of the court's consternation with \textit{Crain}, it received numerous other tax protestor appeals. In \textit{Davis v. United States},\textsuperscript{228} the taxpayers filed a form 1040 claiming four exemptions and itemized deductions. They listed no income though they attached their W-2 forms to the return showing income in excess of $60,000. The IRS imposed a penalty tax under section 6702 of the Code for filing a frivolous return;\textsuperscript{229} taxpayers paid fifteen percent of the penalty and filed a claim for refund of $33,444 for taxes paid in the years 1979 through 1982 and for $50,000,000 in damages for mental and physical suffering.\textsuperscript{230} The Fifth Circuit ruled that the IRS could impose a penalty tax, that the taxpayer's claims for a refund were frivolous, and that a request for compensatory damages was barred by the doctrine of sovereign immunity.\textsuperscript{231} In \textit{Hallowell v. Commissioner},\textsuperscript{232} taxpayers filed a form 1040 which, except for their names, addresses, and filing status, contained only the words "object: self incrimination" or "none" on all the lines of the return relevant to determining tax liability.\textsuperscript{233} The IRS assessed liability for income taxes as well as penalties for failure to file a timely return, for negligence or intentional disregard of tax laws, and for failure to pay estimated income tax.\textsuperscript{234} At trial in the Tax Court, the taxpayers refused to offer any evidence, relying on their fourth and fifth amendment rights. The Tax Court held for the IRS and found that the Commissioner had upheld his burden of proving that at least a portion of the underpayment of taxes was due to fraud.\textsuperscript{235} Upon appeal, the Fifth Circuit held that the taxpayers' arguments that their refusal to complete form 1040 and to testify or produce documents was based on their fourth and fifth amendment privilege was "without even a semblance of merit."\textsuperscript{236}

\begin{itemize}
\item \textsuperscript{227} Id.
\item \textsuperscript{228} 742 F.2d 171 (5th Cir. Aug. 1984).
\item \textsuperscript{229} Id. at 171. Section 6702 imposes a $500 penalty on any individual who files what purports to be a tax return when the return contains information that on its face indicates the self-assessment is substantially incorrect and is based on a frivolous position. I.R.C. § 6702 (1982).
\item \textsuperscript{230} 742 F.2d at 172.
\item \textsuperscript{231} Id. at 172-73.
\item \textsuperscript{232} 744 F.2d 406 (5th Cir. Sept. 1984).
\item \textsuperscript{233} Id. at 407.
\item \textsuperscript{234} Id. at 408.
\item \textsuperscript{235} Id.
\item \textsuperscript{236} Id.
\end{itemize}
cuit awarded the government twice the cost of the appeal plus a damage award of $2000.237

In Stites v. United States,238 taxpayers sued for a refund of all taxes "erroneously and illegally collected through fear and intimidation for the years of 1979, 1980, 1981, 1982," alleging that federal income and social security taxes are unconstitutional.239 The district court dismissed the action, finding the suit frivolous.240 Upon appeal, the Fifth Circuit deemed the case to be another one "in which citizens take it upon themselves to impose upon the federal courts their frivolous and irresponsible claims that wages are not income and that federal income and social security taxes are unconstitutional."241 The court noted that the extensive costs of the judicial process in cases such as these are ultimately borne by those taxpayers who recognize their responsibilities to support their government.242 The court did diminish some of that burden by taxing the appellants double costs for the "frivolous, utterly groundless, appeal."243

In Knoblauch v. Commissioner,244 the taxpayer argued that the sixteenth amendment was not constitutionally adopted because Ohio was not a state when it ratified the amendment and because William Howard Taft, being from Ohio, was not legally President at the time.245 The Fifth Circuit awarded the government double costs and, upon a later submission of its petition for damages in the form of attorney fees, awarded attorney fees.246

In Wright v. Commissioner,247 taxpayer filed a form 1040 with only his name and address. He placed the word "object" on every other line of the return. Upon trial of his petition in the Tax Court for a redetermination of tax deficiencies, including negligence penalties, taxpayer refused to testify, claiming a fifth amendment objection. The Fifth Circuit awarded the government double costs for the taxpayer's appeal of the Tax Court decision, plus reserved the government the right, upon timely petition, to have the court fix reasonable

237. Id. at 409.
238. 746 F.2d 1085 (5th Cir. Nov. 1984).
239. Id.
240. Id. at 1085-86.
241. Id.
242. Id. at 1088.
243. Id.
244. 749 F.2d 200 (5th Cir. Dec. 1984).
245. Id. at 201.
247. 752 F.2d 1059 (5th Cir. Feb. 1985).
attorney fees.\textsuperscript{248}

In \textit{Anderson v. United States},\textsuperscript{249} taxpayers filed a form 1040 but reported no income. Taxpayers attached copies of W-2 forms and 1099 forms, but wrote the word "incorrect" across the face.\textsuperscript{250} Taxpayers paid fifteen percent of a $500 penalty levied by the IRS pursuant to section 6702 of the Code and filed for a refund.\textsuperscript{251} The Fifth Circuit again awarded the government double the cost of appeal plus reasonable attorney fees.\textsuperscript{252}

In \textit{Stelly v. Commissioner},\textsuperscript{253} the Fifth Circuit again awarded the IRS double costs for a frivolous appeal. Taxpayers in \textit{Stelly} contended that only "gains" should be taxed. They asserted that compensation for labor is not gain because there is an even exchange in that the employee provides services equal in value to the wage earned.\textsuperscript{254} The taxpayers contended that while extra compensation, such as a bonus, could be taxed as a "gain," the taxing of regular wages would be unconstitutional.\textsuperscript{255} Even though the taxpayers in \textit{Stelly} appeared before the court \textit{pro se}, the court imposed double costs and attorney fees.\textsuperscript{256}

A different type of tax protest occurred in \textit{United States v. Reeves}.\textsuperscript{257} Taxpayer in that case was being investigated by agents of the Criminal Investigation Division of the IRS. Third-party summonses were issued to seven financial institutions. Rather than attempt to quash the summonses, taxpayer filed a common-law lien against the residence of one of the agents in the amount of $250,000.\textsuperscript{258} Taxpayer maintained he placed the lien on the agent's property in preparation for a suit he planned to bring against the agent and the IRS for violation of his constitutional rights.\textsuperscript{259} The taxpayer was convicted in the district court of "corruptly" endeavoring to obstruct the administration of the internal revenue laws under section 7212(a) of the Code and was sentenced to three years in

\begin{itemize}
\item \textsuperscript{248} \textit{Id.} at 1063.
\item \textsuperscript{249} 754 F.2d \textit{1270} (5th Cir. Mar. 1985).
\item \textsuperscript{250} \textit{Id.} at 1271.
\item \textsuperscript{251} \textit{Id.} at 1272.
\item \textsuperscript{252} \textit{Id.}
\item \textsuperscript{253} 761 F.2d \textit{1113} (5th Cir. June 1985).
\item \textsuperscript{254} \textit{Id.} at 1115.
\item \textsuperscript{255} \textit{Id.}
\item \textsuperscript{256} \textit{Id.} at 1116.
\item \textsuperscript{257} 752 F.2d \textit{995} (5th Cir. Jan. 1985).
\item \textsuperscript{258} \textit{Id.} at \textit{996-97}.
\item \textsuperscript{259} \textit{Id.} at 997.
\end{itemize}
The district court determined that "corruptly" means "with improper motive or bad or evil purpose." The Fifth Circuit agreed that the Tax Court's definition of "corruptly" was too broad, stating that "[a] disgruntled taxpayer may annoy a revenue agent with no intent to gain any advantage or benefit other than the satisfaction of annoying the agent." While the agent would have a state civil remedy against the taxpayer, so long as the taxpayer's actions do not involve force or the threat of force, they would not violate section 7212(a). The Fifth Circuit had previously held that the filing of a nonfrivolous criminal complaint against an agent of the IRS was protected under the first amendment even where the filing was motivated by a bad or improper desire to impede the agent's investigation. Consequently, the court reasoned, even though the filing of a frivolous common-law lien would not be protected by the first amendment, it would at least be "adjacent to areas of protected activity." The Fifth Circuit did hold, however, that if the filing of the frivolous common-law liens were for the purpose of securing improper benefits or advantages for the taxpayer or for others, it would constitute a prohibited corrupt endeavor under section 7212(a). Thus, the court remanded the case for reconsideration consistent with its holding that "improper motive or bad or wicked purpose" was too broad a definition of "corruptly" in that such a definition could include simple contrariness. The district court was left to its discretion as to whether a new trial was necessary.

Judge Williams dissented in Reeves, stating that "[t]he ingenious 'tax protestors' and their advisors continue to create outlandish claims and devices to try to avoid paying their fair share of the costs of supporting the nation of which they are citizens." Judge Williams was of the opinion that the taxpayer's action in filing a quarter-million dollar lien on the residence of the IRS agent was as

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260. Id. The district court later reduced the sentence to two years. Id.
261. Id.
262. Id.
263. Id. at 999.
264. Id.
265. United States v. Hylton, 710 F.2d 1106, 1112 (5th Cir. 1983).
266. Reeves, 752 F.2d at 1001.
267. Id.
268. Id.
269. Id. at 1002 (Williams, J., dissenting).
"clear and blatant a corrupt action designed to impede the collection of taxes as one could imagine." The dissent pointed out that the case was not a trial to a jury; thus, assuming that the court's interpretation of the word "corruptly" was too broad to be a proper jury instruction, the issue before the court was whether the action of the taxpayer in placing the lien on the agent's property was corrupt. According to the dissent, it was corrupt under any definition of the word; consequently, a too broad definition of "corrupt" would be harmless error.

IX. SALE OF A TAX SHELTER

In United States v. Buttorff, the Fifth Circuit affirmed a district court's injunction against the promotion and sale of a kit of trust forms advertised to enable the purchaser "to avoid probate, significantly reduce income tax liability, and keep financial dealings private." Section 7408 of the Code provides that action may be brought by the IRS to enjoin any person from promoting abusive tax shelters. Action is brought in the federal district court in which the person resides, has his principal place of business, or has engaged in such activity. The Fifth Circuit cited numerous cases that have "consistently invalidated similar trusts for federal income tax purposes on an individual taxpayer basis." The purchasers of the trusts in Buttorff were told that they could convey their personal assets, such as cars and residences, to a trust and could then deduct

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270. Id.
271. Id. at 1004.
273. Id. at 1057.
275. 761 F.2d at 1060; see e.g., Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984) (foreign trusts set up by taxpayers to avoid taxes on income from properties in the United States were invalid); Holman v. United States, 728 F.2d 462, 465 (10th Cir. 1984) (taxpayers taxed on income conveyed to "family trust" because trust was mere sham and lacked any economic substance); O'Donnell v. Commissioner, 726 F.2d 679, 682 (11th Cir. 1984) (contributions made to family trust from salary payments); Hanson v. Commissioner, 696 F.2d 1232, 1234 (9th Cir. 1983) (trust created by taxpayers was merely an anticipatory assignment of income).
extensive personal consumption expenses, such as insurance, utilities, or repairs, on these assets.276 According to the court, unless the taxpayer's use of the trust form was enjoined, such fraudulent misrepresentations would continue.277 While the taxpayer argued that an injunction would prevent him from pursuing his occupation of tax planning and counseling, the court noted that such a trust was a mere sham and afforded no tax benefits; consequently, in the limited context of a commercial sale of trust or similar scheme which includes misleading representations of the tax benefits of such trusts, the court reasoned that such activity could be enjoined.278

Taxpayer in *Buttorff* also contended that an injunction would be a prior restraint on his first amendment right to engage in commercial speech for profit.279 However, the Fifth Circuit pointed out that there is an exception to the first amendment for pure commercial speech “which is both misleading and tends to promote illegal conduct.”280

276. 761 F.2d at 1060.
277. Id. at 1063.
278. Id. at 1066.
279. Id. A similar issue is currently pending before the Supreme Court by virtue of its grant of certiorari in SEC v. Lowe, 725 F.2d 892 (2d Cir.), cert. granted, 105 S. Ct. 81 (1984). In *Lowe*, the Second Circuit held that a district court erred in refusing, on first amendment grounds, to grant the SEC an injunction to prohibit the defendant from distributing an investment advisory service. Id. at 902.
280. 761 F.2d at 1068.