FEDERAL INCOME TAXATION

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I. CORPORATIONS.............................................................................................. 308
   A. Section 351 Transfers ............................................................................. 308
   B. Classification of a Corporate Asset as a Capital Asset......................... 310
   C. Subchapter S Corporations .................................................................... 311
      1. Guaranteed Debt .............................................................................. 311

II. INTERNATIONAL TAX PROBLEMS......................................................... 314
   A. “Bona Fide Resident” of a Foreign Country .......................................... 314
   B. Status of IRS as a Creditor in Bankruptcy Proceedings for a Foreign Corporation .... 315

III. TAX ACCOUNTING PROBLEMS.............................................................. 316
   A. When Self-Employment Taxes Become “Payable” in Bankruptcy Proceedings .......... 316
   B. Anticipatory Assignment of Income ..................................................... 317
   C. Cash Receipts Method of Reporting Taxable Income—Check as a Cash Equivalent ...... 318
   D. Taxability of Contributions to a State Retirement Plan ............................ 319
   E. Transfer of Overriding Royalties Triggering a Recapture of Intangible Drilling and Development Costs ......................................................... 320

IV. ESTATE TAX................................................................................................. 321
   A. Inclusion of Life Insurance Proceeds in Decedent's Estate when Decedent-Insured Paid the Policy Premiums ............................................................... 321
   B. Marital Deduction for Bequest Conditioned Upon Survival Until Probate of Decedent Spouse's Will .......................................................... 323
   C. Value of Usufruct for Estate Tax Purposes ........................................... 324

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The Fifth Circuit issued thirty-two decisions involving federal taxation issues during the current survey period. The court ruled that a shareholder’s guaranty of a third party loan to a Subchapter S corporation will not result in an increase in a shareholder’s basis so as to permit the shareholder to deduct additional losses incurred by an S corporation.1 The Fifth Circuit also ruled that the procedural provisions relating to the audit of partnerships apply to S corporations; thus, if an S corporation has ten or fewer shareholders, it is exempt from unitary audit proceedings.2 The court criticized the Internal Revenue Service (IRS) for continually litigating the issue of whether life insurance proceeds are in a decedent’s estate when the decedent had paid the premiums on the policy.3 The Fifth Circuit further expressed disapproval of the recurring IRS decisions to litigate a tax issue in “circuit after circuit” in the hope of establishing a conflict.4

I. CORPORATIONS

A. Section 351 Transfers

Section 351 of the Internal Revenue Code provides that a transfer to a corporation is not a taxable transaction if the transaction is a

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2. See Arenjay Corp. v. Commissioner, 920 F.2d 269, 270 (5th Cir. Jan. 1991); infra notes 50-60 and accompanying text (discussing Arenjay).
4. See 931 F.2d at 1046. The court referred to a taxpayer caught in such an attempt “to whip a dead horse” as “the Commissioner’s guinea pig.” Id.
transfer of property for stock, and the persons transferring such property are in control of the corporation immediately after the transfer.\(^5\) A transfer that fails to meet the requirements of section 351 is a taxable event.\(^6\) Because section 351 provides for the nonrecognition of gain on transfers to controlled corporations, it is generally regarded as a relief provision favoring taxpayers. There are situations, however, where the avoidance of section 351 produces a more advantageous tax result. The transferors might prefer to recognize gain on the transfer of property if they are not particularly harmed by the gain because they are in low tax brackets or because they can report the gain over time by characterizing the sale as an installment sale.\(^7\) By avoiding section 351, the corporation will have a stepped-up tax basis in the transferred assets.\(^8\) If a taxpayer structures a transfer to a controlled corporation so that section 351 is avoided, the taxpayer will have difficulty in later contending that the transfer should fall under section 351.

In *Utley v. Commissioner*,\(^9\) the Fifth Circuit did not permit a taxpayer to restructure a transfer of property to a wholly owned corporation, originally characterized as an installment sale, as a contribution to capital or a section 351 transaction even though the corporation did not issue a promissory note to the transferor-shareholder.\(^10\) Furthermore, when the balance of the installment obligation was "corrected" on the corporate books, in the same year the property was transferred to the corporation, by crediting the balance due on the installment obligation to paid-in capital, the court agreed with the IRS that the shareholder-transferor had gain from the cancellation of an installment obligation under section 453(d).\(^11\) While the Fifth Circuit’s decision seems harsh, the severity of the court’s decision is mitigated by the fact that the transferee-corporation used a stepped-up basis in the transferred property for purposes of computing its depreciation deductions even after the year of the transfer.\(^12\)

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10. *Id.* at 1038.
11. *Id.* at 1039.
12. See *id.* at 1036-37. The court noted that the corporation carried the property on its books at a stepped-up basis consistent with a sale, rather than a carryover basis consistent
The court noted that the taxpayer had originally structured the transfer as an installment sale. Thus, the court decided that the taxpayer could not recast the transfer as a nonrecognition event under section 351.13

B. Classification of a Corporate Asset as a Capital Asset

The Fifth Circuit ruled that a house purchased by a corporation pursuant to an employment contract is a capital asset; thus, a loss incurred by the corporation upon the sale of the house would not be an ordinary loss under section 165 of the Code.14 In Azar Nut Co. v. Commissioner,15 a corporation purchased an employee’s house pursuant to a contract with the employee requiring the corporation to purchase the employee’s house should the employee be terminated.16 The corporation terminated the employee, purchased the house, and later sold it for a loss of approximately $110,000.17 As a result, the corporation deducted the loss as an ordinary and necessary business expense on its tax return.18

The corporation relied on the Supreme Court decision in Corn Products Refining Co. v. Commissioner,19 for its position that the house was exempt from capital asset treatment under section 1221 of the Code.20 It contended that the house was purchased with a “business purpose.”21 However, the Fifth Circuit noted that the Supreme Court renounced Corn Products in Arkansas Best Corp. v.
Commissioner. As the Fifth Circuit stated, the Supreme Court, in Arkansas Best, held that business purpose is irrelevant in determining whether an asset falls within the general definition of a "capital asset." The court decided that the house played "no role" in the corporation's business. The fact that the corporation was required to purchase the house did not convert it into a business asset.

C. Subchapter S Corporations

1. Guaranteed Debt

Section 1366 of the Internal Revenue Code permits a shareholder to deduct his or her proportionate share of losses incurred by an S corporation to the extent of the shareholder's stock basis and any corporate indebtedness to the shareholder. A shareholder may not increase his or her stock basis to permit the deduction of additional losses for the amount of any corporate indebtedness to third parties. Still, in Selfe v. United States, the Eleventh Circuit held that a shareholder's guaranty of a Subchapter S corporation loan could result in an increase in equity or debt even though the shareholder had not paid any portion of the obligation if the loan was, in effect, a loan to the shareholders rather than to the corporation. The Eleventh Circuit remanded Selfe to the district court, instructing it to employ debt/equity principles to determine if the loan in Selfe was, in substance, one to the shareholder rather than to the corporation.

23. 931 F.2d at 317.
24. Id.
25. Id. at 317-18. There is some question as to why the corporation did not claim a compensation deduction in the year it purchased the residence measured by the difference between the purchase price and the fair market value of the house. Of course, in that event, the employee would have had compensation income for the same amount.
27. I.R.C. § 1367(a) (1988). The basis rules for shareholders of a Subchapter S corporation are somewhat similar to the rules for determining a partner's basis in a partnership interest. However, a partner's basis in a partnership interest includes the partner's investment plus the partner's ratable share of any partnership liabilities. See I.R.C. § 752(a) (1988). Thus, a partner is entitled to deduct a greater share of business entity loss than is a shareholder in a S corporation.
28. 778 F.2d 769 (11th Cir. 1985).
29. Id. at 775. See 902 F.2d at 443.
30. 778 F.2d at 775. See 902 F.2d at 443.
The possibility of increasing a shareholder's basis in stock in a Subchapter S corporation, thus permitting the shareholder to deduct a greater amount of losses generated by the corporation, was rejected by the Fifth Circuit in *Harris v. United States*.\(^3\) In *Harris*, the Fifth Circuit ruled that a shareholder in a Subchapter S corporation may not increase his or her stock basis for the amount of a loan to the corporation even though the shareholders personally guaranteed the loan and pledged their individual properties as security for the loan.\(^2\)

The shareholders in *Harris* each initially contributed one thousand dollars to a newly formed Subchapter S corporation.\(^3\) Later, each shareholder loaned the corporation $47,500 to satisfy corporate operating expenses.\(^4\) The corporation then borrowed $700,000 to purchase corporate property with each shareholder personally guaranteeing the loan.\(^5\) In the corporation's first tax year, the corporation reported a net operating loss of $104,013.\(^6\) The two shareholders each reported one-half of the loss on their individual returns.\(^7\) The IRS limited the shareholders' loss to $48,500; the amount of their initial investment plus the amount of corporate indebtedness owed them.\(^8\) The shareholders in *Harris* contended that the $700,000 corporate loan should be recast as a loan from the third-party creditor to them, the proceeds of which they contributed to the corporation's capital account.\(^9\) The shareholders suggested that the Fifth Circuit employ the debt/equity principles espoused in *Plantation Patterns, Inc. v. Commissioner*\(^40\) in determining whether the shareholders had actually made an economic outlay.\(^41\) In *Plantation Patterns*, the Fifth

\(^{31}\) 902 F.2d 439 (5th Cir. June 1991).
\(^{32}\) Id. at 445.
\(^{33}\) Id. at 440.
\(^{34}\) Id.
\(^{35}\) Id.
\(^{36}\) Id.
\(^{37}\) Id. at 441.
\(^{38}\) Id. If the shareholders had not incorporated, but had operated the business as a partnership, they could have deducted their entire share of the net operating loss. *Id.*
\(^{39}\) Id. at 442.
\(^{40}\) 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).
\(^{41}\) 902 F.2d at 442. In *Plantation Patterns*, the Fifth Circuit used a debt/equity analysis to determine whether a corporation could deduct interest payments on its debentures (which were guaranteed by its shareholders) or whether the debt should be classified as equity and, thus, interest payments would constitute dividend income to the shareholders (with no corresponding deduction to the corporation). 462 F.2d at 722. The Fifth Circuit concluded, in *Plantation Patterns*, that the debt was in essence a loan to the shareholders and a corresponding
Circuit determined that when shareholders personally guarantee a loan to a corporation, the debt represented equity rather than debt.42 However, the decision in Plantation Patterns was detrimental to the taxpayer. Because the debt in Plantation Patterns was reclassified as equity under section 385 of the Code, the corporation could not deduct interest payments on the debt. In addition, the interest and principal payments were dividend income to the shareholders.43

The Fifth Circuit declined to adopt its reasoning in Plantation Patterns to benefit the shareholders in Harris.44 It concluded that the shareholders in Harris intended that the loan be one to the corporation.45 According to the Fifth Circuit, a taxpayer “may not in hindsight recast the transaction as one they might have made in order to obtain tax advantages.”46

The Fifth Circuit’s ruling in Harris followed the reasoning of the Sixth Circuit in Brown v. Commissioner47 and the Fourth Circuit in Estate of Leavitt v. Commissioner.48 Because three circuits, the Fourth, Sixth, and now the Fifth, have held that a shareholder’s guaranty of a Subchapter S corporation loan will not result in an increase in a shareholder’s stock basis, shareholders will have difficulty in relying on the Eleventh Circuit’s contrary holding in Selfe49 to increase their share of losses generated by S Corporations. To minimize taxes, shareholders of an S Corporation should borrow, on an individual basis, the needed corporate funds and then, in turn, loan the money personally to the S corporation.

2. Procedural Provisions Applicable to Subchapter S Corporations

In Arenjay Corp. v. Commissioner,50 the Fifth Circuit ruled that

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42. 462 F.2d at 723-24.
43. Id. The payments were deemed to be dividend payments to the shareholders who, in turn, paid the principal and interest on the indebtedness. Id.
44. 902 F.2d at 442.
45. See id. at 443.
46. Id. The Fifth Circuit commented that this rule does not apply to the IRS, for the IRS may often “disregard form and recharacterize a transaction by looking to its substance.” Id. See Higgins v. Smith, 308 U.S. 473 (1940); Williams v. Commissioner, 429 U.S. 569 (1977); Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974).
47. 706 F.2d 755 (6th Cir. 1983).
49. 778 F.2d 769 (11th Cir. 1985).
50. 920 F.2d 269 (5th Cir. June 1990).
the procedural provisions relating to the audit of partnerships also apply to Subchapter S corporations. The IRS determines the tax treatment of partnership items at the partnership level in a unified partnership proceeding, rather than examining separately the return of each partner. If the IRS determines that an adjustment is warranted with respect to a partnership item, the IRS will issue a Notice of Final Administrative Adjustment to each partner. If a partner is dissatisfied, the designated "tax matters person" may institute a court proceeding for readjustment of the items. Section 6231(a)(1)(B), known as the "small partnership exception, provides partnerships with ten or fewer partners with an exemption from the partnership audit and litigation procedures." As the Fifth Circuit noted, the tax treatment of small partnerships is determined at the individual partner level, rather than at the partnership level. Further, section 6244 of the Code makes section 6231(a)(1)(B) applicable to the S corporation. The Fifth Circuit decided that these statutory provisions are unambiguous. Thus, S corporations are governed by the same rules applicable to partnerships. If an S corporation has ten or fewer shareholders, it is exempt from the unitary proceedings.

II. INTERNATIONAL TAX PROBLEMS

A. "Bona Fide Resident" of a Foreign Country

Section 911 of the Internal Revenue Code provides for a foreign earned income exclusion for United States citizens who work abroad. The exclusion is available to an individual who has a tax home in a foreign country and is either a "bona fide resident" of a foreign country for an uninterrupted period or is physically present in a foreign country for at least 330 days of a year. The Fifth Circuit

51. Id. at 270.
52. Id.
53. Id.
54. Id.
55. Id.
56. Id.
57. Id.
58. Id. at 271.
59. Id.
60. Id.
considered the meaning of "bona fide resident" in Jones v. Commissioner.63

The tax court in Jones determined that Jones was not a "bona fide resident" of Japan, apparently because Jones was living in a hotel in Japan rather than renting an apartment or a home, and because Jones' wife did not move to Japan.64 The Fifth Circuit, however, recognized that residence is "much less than domicile which requires an intent to make a fixed and permanent home."65 According to the Fifth Circuit, a taxpayer's intent plays the most important part in determining the establishment and maintenance of a foreign residence.66 The court noted that Jones intended to live and work in Japan until his retirement.67 Further, the court stated that a taxpayer need not establish a "fixed, permanent place of abode in order to be a 'resident' of a foreign country."68 Although the court noted that Jones did not learn to speak Japanese and "was relatively unassimilated into the Japanese culture,"69 it nonetheless decided that Jones was not a "mere transient or sojourner" in Japan.70 The court emphasized that Jones' purpose in being in Japan required him to remain there for at least eight years.71 Apparently, physical presence in a foreign country that is consistent with employment for a long period of time can cause a taxpayer to become a "bona fide resident" of that country.72

B. Status of IRS as a Creditor in Bankruptcy Proceedings for a Foreign Corporation

The IRS has the status of a priority creditor in bankruptcy proceedings in the United States.73 In Overseas Inns S.A., P.A. v.

63. 927 F.2d 849 (5th Cir. Apr. 1991).
64. See id. at 854-55.
65. Id. at 853. The Fifth Circuit pointed to the factors, first enunciated by the Seventh Circuit in Sochurek v. Commissioner, 300 F.2d 34 (7th Cir. 1962), to determine whether a taxpayer is a bona fide resident of a foreign country. 927 F.2d at 853. It also noted the test of alien residency as established in section 871 of the Code and in section 1.871-2(b) of the Treasury Regulations. Id.
66. 927 F.2d. at 854.
67. Id.
68. Id.
69. Id. at 855.
70. Id.
71. Id.
72. See id. at 854. The court noted that Jones paid resident Japanese income taxes and that his employer, in withholding Japanese income tax from Jones' payroll checks, recognized Jones as a Japanese resident. Id.
United States, the Fifth Circuit considered the IRS status in a foreign bankruptcy proceeding when the laws of the country involved characterized the IRS as an unsecured creditor. In response to the taxpayer’s assertion in Overseas Inns that the court should accord comity to the foreign plan of reorganization, the Fifth Circuit commented that “comity is more likely to be accorded foreign bankruptcy decrees when the foreign law is comparable to United States law.”

The Fifth Circuit decided that because “public policy favors payment of lawfully owed federal income taxes,” the corporation could not reduce its tax liability by treating the IRS as an unsecured creditor. The court commented that the corporation availed itself of the benefits of the United States business climate, and thus should not be “allowed to escape the corresponding tax burden.”

III. TAX ACCOUNTING PROBLEMS

A. When Self-Employment Taxes Become “Payable” in Bankruptcy Proceedings

The Fifth Circuit ruled that self-employment taxes become “payable” when taxpayers are required to file their income tax returns and not when installment payments are due. In In re Ripley, the IRS failed to file a proof of claim for a bankrupt taxpayer’s self-employment taxes owed the IRS within ninety days after the first date set for the meeting of creditors. The Ripleys filed a petition

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74. 911 F.2d 1146 (5th Cir. Sept. 1990).
75. Id. at 1147.
76. Id. at 1149. The court stated that American courts have declined to accord comity to foreign decrees when it would prejudice American interests or policies. Id. The court then decided that foreign bankruptcy laws that denied the IRS priority creditor status were “dissimilar and prejudicial.” Id. at 1150. As an unsecured creditor of Overseas Inns, the IRS would have received only 23.49% of its tax deficiency. Id. at 1147. Thus, according to the Fifth Circuit, United States’ courts should not accord comity to such a law. See id. at 1150.
77. Id. at 1149-50.
78. Id. at 1150.
80. Id.
81. Id. at 442. Bankruptcy Rule 3002 provides that a proof of claim must be filed within ninety days after the first date set for the meeting of creditors in a chapter seven liquidation or a chapter thirteen individual’s debt adjustment case. 11 U.S.C. Rule 3002(c) (1989). The required meeting of creditors is set out in 11 U.S.C. section 341(a). See 11 U.S.C. § 341(a).
in bankruptcy under chapter 13 of the Bankruptcy Code in November of 1987. Schedules accompanying the Ripley's petition indicated that the IRS held a priority claim of $21,000. The IRS filed its proof of claim in May of 1988 after the Ripleys filed their 1987 income tax return. The IRS filed its claim pursuant to section 1305 of the Bankruptcy Code which permits claimants to file proofs of claims that "become payable" after commencement of the bankruptcy proceeding. The bankruptcy court agreed with the Ripleys that the employment taxes were "payable" when their quarterly installment payments were due in the first three quarters of 1987, and rejected the IRS proof of claim as being untimely filed. The Fifth Circuit, on the other hand, correctly held that the self-employment taxes "became payable" when the Ripleys were required to file their income tax return; thus, the IRS proof of claim was properly filed under section 1305.

The Fifth Circuit noted that it had never determined when taxes "become payable" for purposes of section 1305. The court decided it must look to the Internal Revenue Code to determine when federal taxes become payable. The Fifth Circuit pointed to section 6201(b)(1) of the Code which provides, in effect, that the IRS must wait until a taxpayer has filed his or her annual tax return before it can seek payment of an unpaid quarterly installment.

B. Anticipatory Assignment of Income

The Fifth Circuit held that a corporation would be taxed on bonuses and delay rentals from mineral leases on corporate property even though it transferred the right to receive such income to its

82. 926 F.2d at 442.
83. Id.
84. Id.
85. Id.
86. Id.
87. Id. at 443, 449.
88. Id. at 444.
89. Id.
90. Id. at 445. The amount of tax owed cannot be determined until the income tax return is actually filed. As the Fifth Circuit noted, the estimated tax payment procedure provides that installment payments must total at least ninety percent of the tax eventually due or one hundred percent of the tax paid in the prior year. Thus, the IRS must wait until the income tax return is filed to determine whether a particular installment payment was deficient. Id. See I.R.C. §§ 6501(a), 6151, 6513(b)(2) (1988).
shareholders. In *C.M. Thibodaux Co., Ltd. v. United States*, a corporation, formed to purchase, hold, manage, and sell real estate and other property for its shareholders, declared a dividend in kind to its shareholders of all outstanding and future mineral royalties on corporate owned property as well as the right to receive all bonuses and delay rentals. The Fifth Circuit reiterated the "fundamental tenet of federal income taxation [that] income is taxable to the one who earns it." The court noted that the corporation retained significant control over the income flow and owned the property on which the mineral leases would be entered. The court dismissed the corporation's argument that under state law the right to receive bonuses and delay rentals is a property right. The court stated that state law characterization of a right to receive income as a property right is "not controlling on the question of which party should pay taxes on the income." Thus, even though the transfer of the right to receive bonuses and delay rentals may be the transfer of a property right under state law, it would also be an anticipatory assignment of future income for purposes of the federal income tax law.

**C. Cash Receipts Method of Reporting Taxable Income—Check as a Cash Equivalent**

The receipt of a check is a cash equivalent for tax purposes. In *Bright v. United States*, the Fifth Circuit addressed the question of whether a check received and deposited near the close of a tax year would represent taxable income for that tax year if the bank in which the check was deposited restricted availability of the funds until the bank had collected the funds from the payor. The taxpayer argued that the check should not be a cash equivalent because it

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92. 915 F.2d 992 (5th Cir. Oct. 1990).
93. Id. at 993-94.
95. 915 F.2d at 995.
96. Id. at 996.
97. Id.
98. Id.
99. See Lavery v. Commissioner, 158 F.2d 859, 860 (7th Cir. 1946); Kahler v. Commissioner, 18 T.C. 31, 34 (1952).
100. 926 F.2d 383 (5th Cir. Feb. 1991).
101. Id. at 385.
failed "the readily marketable and immediately convertible test" set out in Cowden v. Commissioner. The Fifth Circuit, in ruling that the check was a cash equivalent, pointed out that the payor bank did not impose any restrictions on the check. Had the taxpayer opened an account at the payor bank, the taxpayer would have had immediate access to the funds. According to the court, the taxpayer exercised an alternative option to immediate access to the funds through the payor bank by depositing the check in another bank which provided limited access to the funds. The court stated that, in doing so, the taxpayer voluntarily subjected herself to a procedure that delayed personal receipt of the funds; thus, the restriction placed upon the check was not one that would cause receipt of the check to be an exception to the income-upon-receipt rule.

D. Taxability of Contributions to a State Retirement Plan

Employer contributions on behalf of employees to qualified retirement plans under section 401 of the Code are not taxable income to the employees until the plan pays the benefits to the employee. Withholdings from an employee’s salary that are contributed to such a plan are, on the other hand, currently taxed to the employee. The tax on these contributions, called "employee contributions" is levied immediately, while the tax on "employer contributions" is deferred until the pension is dispersed. Thus, the tax consequences of the distinction between the two types of contributions is significant.

Section 414(h) of the Code provides a benefit for employees of state and local governments. Amounts contributed to a plan qualified under section 401(a) by state employees will not be treated as employee contributions if the governmental agency "picks up" the contributions. The Fifth Circuit addressed the question of when

102. 289 F.2d 20, 22 (5th Cir. 1961). See 926 F.2d at 387.
103. 926 F.2d at 386.
104. See id.
105. Id.
106. Id. at 386-87.
109. Id.
111. See 920 F.2d at 1200.
employee contributions are "picked up" in Foil v. Commissioner.\textsuperscript{112} The IRS has established in revenue rulings that a governmental employer must satisfy two criteria to have its employees' contributions "picked up" under section 414(h)(2):\textsuperscript{113}

(1) the employer must specify that the contributions, even though designed as 'employee contributions,' are being paid by the employer in lieu of contributions by the employee; and (2) the employer cannot permit the employee the option of choosing to receive amounts directly instead of having them paid by the employer to the pension plan.\textsuperscript{114} The Fifth Circuit determined that the criteria were reasonable and applied the requirements to a state plan permitting state judges to contribute a part of their monthly income to a state pension plan.\textsuperscript{115} The court held that the "employee contributions" under the state plan were not "picked up" by the governmental employer because the judges had the option of becoming a member of the state retirement system.\textsuperscript{116} Thus, the court ruled that the judge-taxpayer could not exclude his contributions to the plan from his taxable income.\textsuperscript{117}

\textit{E. Transfer of Overriding Royalties Triggering a Recapture of Intangible Drilling and Development Costs}

Taxpayers may elect to deduct intangible drilling and development costs (IDC) pursuant to section 263(c) of the Code.\textsuperscript{118} However, when a taxpayer disposes of "oil, gas, or geothermal property," section 1254 of the Code requires that the taxpayer recapture as ordinary income the aggregate amount of deductible IDC expenditures allocable to such property.\textsuperscript{119} In \textit{Houston Oil and Minerals Corp. v. Commissioner},\textsuperscript{120} a corporation that had substantial IDC

\begin{footnotes}
\item[112] 920 F.2d 1196 (5th Cir. Dec. 1990).
\item[114] 920 F.2d at 1202.
\item[115] Id. at 1203.
\item[116] Id. at 1204.
\item[117] Id. at 1210.
\item[118] I.R.C. § 263(c) (1988).
\item[120] 922 F.2d 283 (5th Cir. Jan. 1991).
\end{footnotes}
deductions conveyed carved out overriding royalty interests in its oil and gas leases to a trust. The IRS determined that the transfer was a disposal of property under section 1254 of the Code. The taxpayer corporation, however, contended that the overriding royalty interests in oil and gas leases were not "oil, gas, or geothermal property" under section 1254. The Fifth Circuit pointed out that under section 1254(a)(3), overriding royalty interests must meet two requirements to qualify as "oil, gas, or geothermal property." The requirements are: (a) the royalty interests must fall within the definition of "property" in section 614 and (b) the royalty interest must be property to which the IDCs "are properly chargeable." The court decided that, because IDCs are "property chargeable" only against working interests, and royalties are nonworking interests the transfer was not a disposal of "property" under section 1254.

IV. ESTATE TAX

A. Inclusion of Life Insurance Proceeds in Decedent's Estate when Decedent-Insured Paid Policy Premiums

The Fifth Circuit ruled that a decedent's payment of the premiums on a life insurance contract on the decedent's life does not cause proceeds of the policy to be in the decedent-insured's estate. In Estate of Perry v. Commissioner, the Fifth Circuit ruled that the only test, as mandated by Congress under section 2035, to

121. Id. at 284.
122. Id.
123. Id. at 284-85.
124. Id. at 285.
125. Id.
126. Id. at 285-86. The IRS expressed concern that the Fifth Circuit's interpretation of § 1254 would lead to abuse. According to the IRS, taxpayers wanting to avoid recapture of IDC could carve out an overriding royalty interest equal to ninety-nine percent of the net profits from the working interest and sell that royalty interest without recognizing any gain. Although the taxpayer would recapture previously deducted IDCs upon disposition of the working interest, the taxpayer would recapture few if any IDCs because the working interest, then devoid of ninety-nine percent of revenue interest, would produce little gain. Id. (The amount of recapture under section 1254 is limited to realized gain.) The Fifth Circuit, on the other hand, opined that such a hypothetical possibility could be overcome by the step-transaction doctrine and the substance-over-form doctrine. See id. at 286.
128. Id.
determine whether insurance proceeds are included in a decedent’s estate is the incidents of ownership test. 129

The court distinguished its earlier decision in Bel v. United States, 130 wherein it applied a “beamed transfer” theory to hold that the decedent’s payment of policy premiums on a policy owned by his children caused the decedent’s actions to be a transfer for purposes of section 2035 even though the decedent held no incidents of ownership in the policy. 131 The court pointed out that although it could not overrule a decision of a prior panel without a decision of the court sitting en banc, the Bel decision was a pre-ERTA decision. 132 According to the court, aspects of Bel which, before ERTA, would require inclusion of policies in a decedent’s gross estate, were no longer viable. 133

The Fifth Circuit was concerned that the IRS has continued to insist on the inclusion in a decedent’s estate of proceeds of life insurance policies when the decedent paid the premiums. 134 The court cited two tax court cases, Leder v. Commissioner, 135 and Estate of Headrick v. Commissioner, 136 affirmed by the Sixth and the Tenth Circuits, that have discredited the IRS position. The tax court pointed out that, in both cases, the cross-reference to section 2042 in section 2035, relied upon by the IRS to include the proceeds in the decedent’s estate, “means that the inclusionary rule of section 2035 no longer applies unless a decedent possessed incidents of ownership in the insurance policy.” 137 The Fifth Circuit noted that the Leder and Headrick decisions, as well as its decision in Estate of Perry, were based on the plain wording of the statute, which, according to the court, was supported “by the clear intention of Congress to do away with the last vestiges of the premium payment test for inclusion of life insurance in gross estates of insureds.” 138 Because the decedent in Estate of Perry never possessed any incidents of ownership in the

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129. Id. at 212-13.
131. Id. at 691. See 927 F.2d at 212.
132. 927 F.2d at 212.
133. Id.
134. See id. at 213.
137. 927 F.2d at 211-2 (emphasis in original).
138. Id. at 212.
insurance policies the court ruled that the proceeds would not be in the decedent's estate.\textsuperscript{139}

The Fifth Circuit decided that the weight of prior decisions caused the IRS position to be no longer "substantially justified," and thus, awarded the taxpayers in \textit{Perry II} attorneys' fees under section 7430 of the Code.\textsuperscript{140} The court warned the IRS that "policy decision[s] to continue to whip a dead horse in circuit after circuit in the hope, however vain, of establishing a conflict," although clearly an option within the discretion of the Commissioner, may cause the IRS to bear "the risk of incurring the obligation to reimburse the taxpayer for attorneys' fees."\textsuperscript{141}

\textbf{B. Marital Deduction for Bequest Conditioned Upon Survival Until Probate of Decedent Spouse's Will}

In \textit{Estate of Robertson v. United States},\textsuperscript{142} the Fifth Circuit ruled that when a spousal bequest was conditioned on the spouse surviving the decedent, that bequest would not qualify for the marital deduction until probate of the decedent's will.\textsuperscript{143} Section 2056 of the Internal Revenue Code provides that a surviving spouse may claim a marital deduction for estate tax purposes for property passing to the surviving spouse; however, an interest that is contingent upon the occurrence or non-occurrence of a certain event is deemed to be a non-deductible, terminable interest.\textsuperscript{144} Still, section 2056(b)(3) provides that an interest passing to a surviving spouse, conditioned only upon the actual survival of the surviving spouse, is not a terminable interest if the death of the surviving spouse will cause a termination or failure of the spousal interest only within six months after the decedent's death and the termination or failure does not in fact occur. In \textit{Estate of Robertson}, the decedent's will bequeathed the decedent's residuary estate to the decedent's husband, but the will contained a paragraph providing that the residuary estate would pass to the decedent's

\textsuperscript{139} \textit{Id.} These policies and all incidents of ownership were owned from their inception by the decedent's sons. \textit{Id.}

\textsuperscript{140} See 931 F.2d 1045. Note the court's suggestion in \textit{Estate of Perry} that taxpayers should seek attorneys' fees. 927 F.2d at 213.

\textsuperscript{141} 931 F.2d at 1046. The court was concerned that innocent taxpayers were required to expend attorneys' fees for "the dubious honor of being the Commissioner's guinea pig." \textit{Id.}

\textsuperscript{142} 903 F.2d 1034 (5th Cir. June 1990).

\textsuperscript{143} \textit{Id.} at 1039.

\textsuperscript{144} See \textit{id.} at 1036.
children if the decedent’s spouse should die before the will was admitted to probate.\textsuperscript{145} The Fifth Circuit decided that because the will could have been admitted to probate under state law more than six months after the decedent’s death, the contingency did not fall within the safe harbour of section 2056(b)(3).\textsuperscript{146} Thus, the bequest to the decedent’s spouse did not qualify for the marital deduction.\textsuperscript{147} The court recognized that its decision was harsh, but decided that it was nonetheless “required by statute.”\textsuperscript{148}

C. Value of Usufruct for Estate Tax Purposes

A usufruct is defined by Louisiana law as “a real right of limited duration on the property of another.”\textsuperscript{149} In \textit{Estate of Carter v. United States},\textsuperscript{150} the Fifth Circuit addressed the question of whether a usufruct had any value that would entitle the estate of a transferee of such an interest an estate tax credit on the transfer of the interest from a decedent’s estate.\textsuperscript{151} In \textit{Estate of Carter}, a husband and wife died in an automobile accident. Although no evidence indicated who had died first, a presumption arose under Louisiana law that the wife died first.\textsuperscript{152} The wife’s will granted her estate in usufruct to her spouse and in naked ownership to her children.\textsuperscript{153} Because of the temporal proximity of their deaths, the period of the husband’s usufruct was of exceedingly short duration, if it, in actuality, ever existed.\textsuperscript{154} The executor of the husband’s estate claimed a “tax on

\begin{itemize}
  \item \textsuperscript{145} \textit{id.}
  \item \textsuperscript{146} \textit{id.} at 1037.
  \item \textsuperscript{147} \textit{id.} at 1039. The Fifth Circuit noted that the Eighth and Second Circuits have also so held. \textit{id.} at 1037-39. \textit{See} Hansen v. Vinal, 413 F.2d 882, 886 (8th Cir. 1969); \textit{In re Estate of Fried}, 445 F.2d 979, 981 (2d Cir. 1971), \textit{cert. denied}, 404 U.S. 1016 (1972). \textit{See also} \textit{Estate of Hein v. Commissioner}, 914 F2d. 1322 (9th Cir. 1990) (Ninth Circuit held that a decedent created a nondeductible terminable interest by requiring his surviving spouse to survive distribution of the estate). \textit{id.} at 1328. The court noted that the will could have been admitted to probate after the decedent’s death. The court stated that the fact that the spouse did, in fact, survive distribution was of no account. \textit{id.}
  \item \textsuperscript{148} \textit{See} 903 F.2d at 1039.
  \item \textsuperscript{149} \textit{See} \textit{Estate of Carter v. United States}, 921 F.2d 63, 64 n.1 (5th Cir. Jan. 1991).
  \item \textsuperscript{150} \textit{id.} at 63.
  \item \textsuperscript{151} \textit{See id.} at 64.
  \item \textsuperscript{152} \textit{id.}
  \item \textsuperscript{153} \textit{id.}
  \item \textsuperscript{154} \textit{id.}
\end{itemize}
prior transfer” credit under section 2013 of the Code for the tax paid by the wife’s estate.\footnote{155}

Section 2013 provides for a reduction in a decedent’s estate tax for all or part of the estate tax paid with respect to the transfer of property by an estate of a person who died within ten years before, or within two years after, the decedent’s death.\footnote{156} The amount of the credit is determined by multiplying the total estate tax paid by the transferor estate by a percentage, the numerator of which is the value of the property transferred and the denominator of which is the total taxable estate of the transferor.\footnote{157} Because the Fifth Circuit decided that a usufruct passing between a transferor and transferee, both of whom died in a common disaster, was valueless, the amount of the credit to the husband’s estate was zero.\footnote{158}

V. Employment Taxes

Employers must maintain the taxes that they withhold on wages paid to employees in trust in a special fund for the United States.\footnote{159} If the employer fails to pay the so-called “trust fund taxes” to the IRS, the responsible directors, officers or employees who “willfully” fail to collect and pay the trust fund taxes are personally liable for a penalty equal to the amount of the delinquent taxes.\footnote{160} The Fifth Circuit considered questions relating to the obligation of a “responsible party” in two cases in the current survey period. It considered employee versus independent contractor status in another case.

In \textit{McCray} v. \textit{United States},\footnote{161} a chair of the board of directors and a vice president of a corporation that failed to pay its trust fund taxes contended that he was not liable for the taxes because he did not “willfully” fail to pay over the trust fund taxes.\footnote{162} He contended that he relied on the other owners, who were in charge of the affairs...
of the business, and the corporation’s accountants and lawyers to see that the taxes were paid. 163 The Fifth Circuit, on the other hand, found that the taxpayer, as chair of the board and vice president, was clearly a responsible party. 164 The court further determined that the taxpayer knew the withheld taxes had not been paid to the IRS, and that so knowing, used corporate funds to pay other creditors before paying the delinquent taxes. 165 Thus, the court ruled that the taxpayer “willfully” withheld tax payments. 166

The court in McCray agreed with the taxpayer that he was entitled to an administrative adjustment for any amount of the trust fund taxes paid by joint debtors. 167 Because responsible parties are jointly and severally liable for delinquent trust funds taxes, 168 the IRS may seek a judgment against each responsible party for the full amount of trust fund taxes due the IRS. 169 Still, because the IRS will collect only one hundred percent of the amount due from any group of jointly liable persons, the IRS will “later abate the total liability by the accumulation of amounts paid by each responsible party.” 170 As the court noted, the abatement does not occur “until the expiration of the statutory period for commencement of a refund suit by any of the responsible parties or, if a refund suit is filed, upon final adjudication of the action.” 171 Because each responsible party in McCray had either reached a binding settlement with the IRS or had a final and unappealed judgment rendered against him or her, the court found that the IRS was no longer in danger of losing its right to collect the full amount due. 172 Thus, the court determined that the IRS could adjust the taxpayer’s liability for the amounts paid by other responsible parties. 173

In Turnbull v. United States, 174 the Fifth Circuit noted that the question of whether an individual is a “responsible party” turns on

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163. Id.
164. Id.
165. Id.
166. Id.
167. Id. at 1291.
168. USLife Title Ins. Co. of Dallas v. Harbison, 784 F.2d 1238, 1243 (5th Cir. 1986). See 910 F.2d at 1290.
169. See id. at 1290.
170. Id.
171. Id.
172. Id.
173. Id.
the individual’s “status, duty, and authority.” The court commented that it has “generally taken a broad view of who qualifies as a responsible person, . . .” stating that the “crucial inquiry is whether the individual had the effective power to pay taxes.”

The Fifth Circuit considers the following factors in deciding whether an individual is a responsible person: (1) whether the individual holds an office or owns stock in the corporation; (2) whether the individual manages the day-to-day operations of the business; (3) whether the individual makes decision as to disbursements of funds and payment of creditors; and (4) whether the individual has the authority to sign checks. The taxpayer in Turnbull contended he was not a responsible party for two quarters in a tax year because he had moved his office to another location and had little contact with the corporation. The Fifth Circuit, however, found that location of an individual’s office does not determine whether the individual is a responsible party. The court noted that the taxpayer still had authority to sign checks on the corporation’s accounts. The court determined that the taxpayer “willfully” failed to pay the trust funds to the IRS because he knew he could not rely on other corporation officers to pay the taxes. The court commented that a responsible party acts “with reckless disregard” when he delegates to another responsible party the duty to pay such taxes and fails to take independent action to procure payment of the taxes.

In Dillon v. Commissioner, the Fifth Circuit ruled that a newspaper carrier is an independent contractor and thus not an employee. The court decided that the newspaper only minimally controlled how the carrier conducted his business. According to

175. Id. at 178.
176. Id.
177. Id. See Howard v. United States, 711 F.2d 729, 734 (5th Cir. 1983); Neckles v. United States, 579 F.2d 938, 940 (5th Cir. 1978).
178. 929 F.2d at 179.
179. Id.
180. Id.
181. Id. The Fifth Circuit has held that the willfulness requirement is satisfied if a responsible person acts with a reckless disregard of a known or obvious risk that trust funds may not be remitted to the government. Gustin v. United States, 876 F.2d 485, 492 (5th Cir. 1989). See 929 F.2d at 180.
182. Id.
183. 902 F.2d 406 (5th Cir. June 1990).
184. Id. at 408-9.
185. Id. at 409.
the court, the newspaper controlled the end results while the carrier controlled the method.186

VI. TAX PROCEDURE

A. Remedies Against Wrongful Action by the IRS

The doctrine of governmental immunity generally prevents suits against the United States without its consent.187 Section 7421 of the Code specifically provides that no suit may be brought to restrain the assessment or collection of any tax either by the person against whom the tax was assessed or by a third party.188 Still, the Code does provide for some actions against the IRS. A taxpayer may file a claim for the refund of a tax liability erroneously or illegally assessed or collected if the taxpayer follows the provisions of section 7422 of the Code.189 A taxpayer may bring an action under section 7431 of the Code for damages should the IRS wrongfully disclose return information,190 and may sue the government pursuant to section 7432 of the Code if any officer or employee of the IRS fails to release a lien when it is required to do so under section 6325 of the Code.191 Furthermore, section 7433 of the Code provides that a taxpayer may institute an action against the government for certain unauthorized collection actions.192 A third party may file a refund suit against the IRS under section 7426 of the Code when the IRS has wrongfully levied on property belonging to the third party.193 Section 2410 of title 28 of the United States Code permits a third party holding title to real estate, subject to a federal tax lien, to sue the government for the purpose of securing an adjudication as to the validity of the lien.194

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186. Id.
Although the above noted statutes provide that taxpayers and third parties may sue the government in the limited circumstances set out in the statutes, courts have held that any such waivers of sovereign immunity must be narrowly construed. Some courts have questioned whether a taxpayer may use section 2410 of title 28 to contest the procedural regularity of a lien by holding that the statute is applicable only to a third party. In McCarty v. United States, the Fifth Circuit decided that, although some jurisdictions have permitted a taxpayer to sue the government under section 2410, a taxpayer could not challenge the merits of an underlying tax assessment in an action under section 2410. The court further determined that section 7426 of the Code is limited by its terms to actions brought by persons other than the taxpayer.

B. Failure to File a Timely Return

Section 6651(a)(1) of the Code provides for penalties for failure to file a tax return by the due date "unless it is shown that such

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195. See, e.g., Estate of Johnson, 836 F.2d 940, 943 (5th Cir. 1988); Garcia v. United States, 776 F.2d 116, 118 (5th Cir. 1985).
196. See, e.g., United States v. Brosnan, 363 U.S. 237, 247 n. 11 (1960); Estate of Johnson v. United States, 836 F.2d 940, 943 (5th Cir. 1988); Robinson v. United States, 920 F.2d 1157, 1161 (3d Cir. 1990); Schmidt v. King, 913 F.2d 837, 839 (10th Cir. 1990); Elias v. Connett, 908 F.2d 521, 527 (9th Cir. 1990); Aqua Bar & Lounge v. United States, 539 F.2d 935, 938-39 (3d Cir. 1976). In Estate of Johnson, the Fifth Circuit decided that the executor of an estate could bring suit against the government to challenge the priority of a tax lien even though the court stated that the decedent "taxpayer" might not have been permitted to file an action under the statute. 836 F.2d at 945-47. There the Fifth Circuit commented that although much debate has centered on the question of whether taxpayers can bring suit to quiet title to property subject to federal tax liens under section 2410 of title 28, it would not decide that issue. Id. at 944-45. Instead it concluded that the executor could bring suit under section 2410 because the executor qualified as a third party. Id. at 947.

The IRS had maintained that for tax purposes the executor was the equivalent of the decedent and, thus, could have no greater rights to bring suit under section 2410 than the decedent. Id. at 945. Although the Fifth Circuit admitted that an executor steps into the shoes of the decedent with respect to federal income tax liabilities, it determined that because the executor was required to pay the debts of the estate, some of which had arisen after the taxpayer's death, the executor was acting as a third party. Id. at 947. Thus, the court determined that the executor could bring an action under section 2410 as a third party. Id.

197. 929 F.2d 1085 (5th Cir. Apr. 1991).
198. See id. at 1087.
199. Id. at 1088. The court stated that a taxpayer could not contest the existence or validity of the tax assessment in an action under section 2410. Id.
200. Id.
failure is due to reasonable cause and not to willful neglect."\(^{201}\) The Fifth Circuit pointed out in *Denenburg v. United States*\(^ {202}\) that any cause for delinquency that appears to a person of "ordinary prudence and intelligence" as a reasonable cause for delay "will be accepted as reasonable."\(^ {203}\) "To demonstrate 'reasonable cause,' a taxpayer must show that he or she exercised 'ordinary business care and prudence.'"\(^ {204}\) The Fifth Circuit in *Denenburg* ruled that the determination of the elements required to be present to constitute "reasonable cause" is a question of law, but a determination of whether those elements are present in a given situation is a question of fact.\(^ {205}\) The court stated that, in determining a question of fact, it views the evidence in the light most favorable to the taxpayer, but it also noted the requirement that the taxpayer bears the burden of proving that the failure to file timely resulted from "reasonable cause."\(^ {206}\)

In *Denenburg*, the Fifth Circuit reviewed its prior decisions regarding whether a taxpayer's reliance on professional advice may constitute reasonable cause for late filing.\(^ {207}\) These decisions have set out the following rules:\(^ {208}\)

1. "[A] taxpayer's reliance on an agent to comply with a fixed and unambiguous statutory deadline for filing returns does not constitute 'reasonable cause' for delay."\(^ {209}\)
2. "[A] taxpayer's reliance on his agent to ascertain the correct filing date for returns does not constitute 'reasonable cause' for delay."\(^ {210}\)
3. "[A] taxpayer's reliance on the advice of his agent that he or she need not meet a return filing deadline (or need not file a return at all) because no taxes are due does not constitute 'reasonable cause' for delay."\(^ {211}\)

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203. *Id.* at 303; *(citing United States v. Boyle, 469 U.S. 241 (1985)).*
204. 920 F.2d at 303; *(citing Treas. Reg. § 301.6651-1(c)(1) (as amended 1973)).*
205. *Id.*
206. *Id.*
207. See *id.*
208. See *id.*
209. *Id.* See *United States v. Boyle, 469 U.S. 241, 251 (1985).*
211. 920 F.2d at 304. See *Jackson v. Commissioner*, 864 F.2d 1521, 1527 (10th Cir. 1989).
(4) "[A] taxpayer's reliance on the advice of his or her accountant or tax attorney that no return is due does constitute 'reasonable cause' for delay." 212

The court in Denenburg decided that the delay in filing caused by the taxpayer's "accounting firm being unwilling to prepare and sign returns which were not supported by business documentation and which did not accurately reflect the true substance of the transaction" 213 did not fall within any of the categories and was not "reasonable cause" for failure to file a timely return. 214

C. Taxpayer's Last Known Address

The assessment of a tax liability is the starting point in the tax collection process. 215 Once assessment is made, the taxpayer must pay the tax; administrative or judicial review generally is no longer available. 216 An assessment is made after a return has been audited or no return was filed, and the taxpayer has been given a ninety-day notice of a tax deficiency resulting from the audit or the failure to file a return. 217 The notice is mailed to the taxpayer at his or her "last known address." 218

The Fifth Circuit earlier ruled that the IRS may not consider the taxpayer's address on the tax return for the year in question as the taxpayer's last known address. 219 The Fifth Circuit has held that the IRS must exercise reasonable diligence to ascertain a taxpayer's address before mailing a notice of deficiency. 220 The Fifth Circuit earlier decided that the current state of the IRS computer capabilities

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213. 920 F.2d at 307.
214. See id.
219. See Mulder v. Commissioner, 855 F.2d 208 (5th Cir. 1988) (discussing prior court decisions that had held that the address on the tax return for the year in question would be the taxpayer's "last known address" in the absence of appropriate notification of an address change).
220. Id. at 212. The Fifth Circuit, in Mulder, decided that if mailings to a taxpayer are returned in any context in which an IRS agent should know the taxpayer has moved, the IRS should contact the tax preparer or the state motor vehicle or license bureau to determine the taxpayer's current address. See id.
permits the IRS to perform a computer search to determine a taxpayer's address without unreasonable effort or delay.221 The Tax Court's current position is that a taxpayer's last known address is the address on the taxpayer's most recently filed return unless the taxpayer has given the IRS clear and concise notification of a different address.222 The Tax Court has ruled that the address appearing on the return is available to the agent issuing a notice of deficiency if the address could be obtained by a computer generation of an IRS computer transcript using the taxpayer's federal identification number.223

In Ward v. Commissioner,224 the Fifth Circuit stated that a taxpayer's "last known address" is the address in light of all surrounding facts and circumstances that the IRS "reasonably believed the taxpayer wished the notice of deficiency to be sent."225 The court decided that the IRS must use "reasonable diligence" to ascertain that address.226 Furthermore, the court stated that it would presume that the IRS used reasonable diligence if it mailed the deficiency notice to the address contained on the taxpayer's most recently filed tax return "unless the taxpayer provided 'clear and concise' notice to the IRS of an address change."227 Because the taxpayer in Ward had written a letter to the IRS notifying it of an address change, the Fifth Circuit determined that the IRS did not mail its deficiency notice to the taxpayer's "last known address" even though the IRS had not completed processing the taxpayer's change of address at the time the deficiency notice was mailed.228

D. Award of Attorneys' Fees to Taxpayer as the Prevailing Party

Section 7430 of the Code provides for an award of reasonable administrative and litigation costs in any administrative or court

221. See Pomeroy v. United States, 864 F.2d 1191 (5th Cir. 1989). Still, the Fifth Circuit in Pomeroy determined that a notice sent to the taxpayer's address on the taxpayer's most recent return and on the two most recent extension requests was sufficient since the taxpayers did not give the IRS clear and concise notice of an address change. Id. at 1194.
223. Id. In the case of a jointly filed return, both taxpayer identification numbers must be used. Id.
224. 907 F.2d 517 (5th Cir. Aug. 1990).
225. Id. at 517.
226. Id.
227. Id.
228. Id. at 521.
proceeding brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty if the taxpayer is a "prevailing party." Reasonable litigation costs include such expenses and fees as well as attorneys' fees up to seventy-five dollars per hour unless the court determines that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys for such proceeding, justifies a higher rate.

In *Bode v. United States*, the Fifth Circuit ruled that an attorney's expertise in tax law is not, in and of itself, a "special factor warranting a fee award in excess of $75 per hour" under section 7430. However, the court found in *Bode* that the complex nature of the underlying merits of the case prevented the taxpayer from obtaining qualified attorneys to handle the case for substantially less than the hourly rate of $150 awarded by the district court. The Fifth Circuit decided that the taxpayer could be awarded attorneys' fees for its appeal if the taxpayer was a prevailing party on appeal. Because the taxpayer was only partly successful on appeal, the court decided that the district court should take evidence on the issue to determine how much of the time billed to the taxpayers by the attorneys for the appellate work was devoted to those issues on which the taxpayer prevailed.

In *Perry II*, the Fifth Circuit held that a decision to appeal a tax case when two other circuits had sustained the taxpayer's position could cause the IRS to be required to pay the taxpayer attorneys' fees pursuant to section 7430 of the Code.

**E. Statute of Limitations in Tax Evasion Cases**

In *United States v. Williams*, the Fifth Circuit held that the limitations period for a prosecution of tax evasion under section 7201

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229. I.R.C. § 7430 (1988). Reasonable administrative costs include the administrative fees or similar charges imposed by the IRS, the fees of expert witnesses, and the expenses of any studies, analyses, engineering reports, tests, or projects found to be necessary for the preparation of the case. See I.R.C. § 7430(c)(2) (1988).
231. 919 F.2d 1044 (5th Cir. Dec. 1990).
232. *Id.* at 1050.
233. *Id.* at 1051.
234. *Id.* at 1052.
235. *Id.*
236. 931 F.2d 1044 (5th Cir. May 1991).
237. *Id.* at 1046.
for failure to file a tax return begins to accrue on the day the tax return was due.\footnote{239} Thus, the court found that taxpayer's indictment for tax evasion was within the six-year limitations period.\footnote{240}

VII. Tax Shelters

The Fifth Circuit continues to be plagued with questions regarding the deductibility of losses in tax shelter investment schemes. In \textit{Freytag v. Commissioner},\footnote{241} the taxpayers were four of approximately 3,000 taxpayers who sought redetermination of deficiencies assessed against them for deducting losses allegedly realized from investments in straddles in forward contracts to buy and sell securities issued by the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation.\footnote{242} Because the Fifth Circuit concluded that the corporation's "absolute authority over the pricing and timing of the transactions that occurred in the self contained market of its own making enabled it to achieve the tax losses desired by its investors with uncanny accuracy,"\footnote{243} the court decided the taxpayers did not enter into the transaction "primarily for profit."\footnote{244} Thus, the Fifth Circuit disallowed the taxpayer's loss deduction.\footnote{245} It also determined that the taxpayers should be subjected to a negligence penalty pursuant to section 6653(a) of the Code.\footnote{246} The court noted that all the taxpayers were professionals with investment experience that, according to the court, should have alerted them to the "questionable financial validity" of the program.\footnote{247} Yet, as the court noted,
none of the taxpayers took "even the most rudimentary steps to investigate the bona fides of the financial aspects" of the investment. 248

In Agro Science Co. v. Commissioner, 249 the court denied partnerships' deductions for expenses incurred in conjunction with research contracts executed with a Brazilian corporation. 250 The contracts provided that the corporation would develop a monoclonal antibody conjugate for which each of the partnerships agreed to pay $600,000, represented by a $75,000 down payment and a promissory note payable in Brazilian cruzerios for the remaining $525,000. 251 As the corporate founder predicted in his promotional dialogues with potential investors, the cruzerio continuously plunged in value so that American dollars could be used to cancel the debt for only a fraction of the $525,000 face value. 252 Thus, investors claimed a $600,000 tax deduction for a $75,000 cash outlay. 253 The Fifth Circuit ruled that because the debt was created for the exclusive purpose of generating tax savings, it was "not genuine and must be regarded for tax purposes." 254 Because the court also found that the partnerships did not intend to profit from the investment in the Brazilian currency, except by tax deductions, 255 the court's "debt-authenticity and profit-motive holdings" foreclosed all deductions at issue. 256

The deductibility of taxpayers' investments in research and experimental expenditures on amphibian aircraft was at issue in Zink v. United States. 257 The Fifth Circuit reviewed de novo the district court's determination that the taxpayers, a retired surgeon and a college professor, had invested in the programs "in a businesslike manner with the intention of making a profit," 258 noting that the question of whether the taxpayers were involved in their own "trade or business" was a question that involved the application of law to

248. Id.
249. 927 F.2d 213 (5th Cir. Mar. 1991) (republished in 934 F.2d 573 (5th Cir. Apr. 1991)).
250. Id. at 214.
251. Id.
253. See id.
254. 927 F.2d at 215.
255. Id.
256. Id. at 216.
257. 929 F.2d 1015 (5th Cir. Apr. 1991).
258. Id. at 1019.
Section 174 of the Code provides that research or experimental expenditures paid or incurred during a taxable year in connection with a "trade or business" may be deducted currently rather than capitalized. The Fifth Circuit decided that the taxpayers' activities in connection with the aircraft program were insufficient, as a matter of law, to establish that the taxpayers were in the airplane business or trade for purposes of section 174. Thus, even if they had the requisite profit motive, the court held they could not deduct the expenditures.

The Fifth Circuit considered the penalty tax for selling allegedly abusive tax shelters in *Sage v. United States*. Pursuant to section 6700 of the Code, which imposes a penalty for persons who sell interests in abusive tax shelters, the IRS assessed penalties of $332,750 against the taxpayer. The taxpayer contended that assessment of the section 6700 penalties was barred by the statute of limitations under section 6501(a) because the assessment was not made within three years of the last limited partnership sale. The court, on the other hand, ruled that the three-year statute of limitations under section 6502(a) did not apply to assessment of penalties for selling interests in abusive tax shelters. The court held that no limitations period exists for assessment of a section 6700 penalty just "as with other provisions of the Code enacted to combat fraud."

The Fifth Circuit also determined that the IRS could "set-off" a tax refund owed the taxpayer against the penalty even though the taxpayer was contesting imposition of the penalty. Further, the court held that the "set-off" did not constitute a "levy" which would be prohibited until a final resolution of the issue of liability for the penalty.

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259. See *id.* at 1020.
261. See 929 F.2d at 1022.
262. *Id.* at 1023.
263. 908 F.2d 18 (5th Cir. Aug. 1990).
264. *Id.* at 20.
265. *Id.*
266. *Id.* at 25.
267. *Id.*
268. *Id.* at 26.
269. *Id.* at 27. The court noted that a "levy" is a means by which the IRS may acquire possession of a taxpayer's property while a "set-off" is the application of funds already in the IRS's possession against a taxpayer's outstanding tax liability. *Id.*
VIII. Conclusion

Most of the Fifth Circuit opinions on federal tax during the current period were routine and thus, not noteworthy. The most significant case was undoubtedly *Harris v. United States*,\(^\text{270}\) in which the court ruled that a shareholder’s guaranty of a third party loan to an S Corporation will not increase the shareholder’s basis so as to permit the shareholder to deduct additional losses incurred by the corporation. The Fifth Circuit’s award of attorneys’ fees to the taxpayer in *Perry II*,\(^\text{271}\) and its stern admonition to the IRS for its practice of litigating issues in several circuits to obtain a conflict among the circuits, should have a chilling effect on the government’s resort to this dubious practice in the future.

The remainder of the noted cases represent thoughtful yet standard applications of provisions of the Internal Revenue Code. Overall the court should be given high marks for its rulings in the current period.

\(^{270}\) 902 F.2d 439 (5th Cir. June 1990); see *supra* notes 31-49 and accompanying text.

\(^{271}\) 931 F.2d 1044 (5th Cir. May. 1991); see *supra* notes 236-37 and accompanying text. See also *Estate of Perry*, 927 F.2d 209 (5th Cir. Mar. 1991); *supra* notes 138-41 and accompanying text.