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The Rehnquist Court: Nineteen Years of Tax Decisions

F. Ladson Boyle

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I. INTRODUCTION

William Rehnquist was first appointed to the Supreme Court by President Nixon in 1973. In 1986, President Reagan nominated Justice Rehnquist to replace Warren Burger as Chief Justice and the Senate confirmed the appointment that year. After nineteen years as Chief Justice, Rehnquist passed away on September 3, 2005. In light of the loss to the legal community, it seems appropriate to review the federal tax decisions of the Rehnquist Court.

During William Rehnquist's nineteen terms as Chief Justice, the Court granted certiorari or heard appeals in approximately sixty federal tax cases.[1] Of these, twenty-three involve procedural matters

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such as statutes of limitations, lien priority, bankruptcy, and Tax Court rules;[2] two decisions involve insurance company taxation;[3] two involve taxation of multinational businesses;[4] and four involve FICA taxes.[5] The remaining twenty-eight decisions address statutes that determine federal income, gift, and estate taxes or consider the constitutionality of those statutes.[6]

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and Greg Flowers for their editing and research assistance and Nancy Shealy for her secretarial support.

1 One decision, *South Carolina v. Baker*, 485 U.S. 505 (1988), was heard in original jurisdiction. In addition, this total does not include decisions where the controlling law is contained in the Internal Revenue Code (Code) unless either the United States or the Commissioner is a litigant. *See, e.g.*, Rousey v. Jacoway, 125 S. Ct. 1561 (2005) (allowing exclusion from bankruptcy estate of assets held in individual retirement accounts governed by the Code). Finally, this list does not include state tax cases or the unique tax cases involving Native Americans.

2 Ballard v. Commissioner, 125 S. Ct. 1270 (2005); United States v. Craft, 535 U.S. 274 (2002); Young v. United States, 535 U.S. 43 (2002); Baral v. United States, 528 U.S. 431 (2000); United States v. Estate of Romani, 523 U.S. 517 (1998); United States v. Brockamp, 519 U.S. 347 (1997); United States v. Jose, 519 U.S. 54 (1996); United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996); United States v. Noland, 517 U.S. 535 (1996); Commissioner v. Lundy, 516 U.S. 235 (1996); United States v. Williams, 514 U.S. 527 (1995); United States v. McDermott, 507 U.S. 447 (1993); Bufferd v. Commissioner, 506 U.S. 523 (1993); Church of Scientology of Cal. v. United States, 506 U.S. 9 (1992); Holywell Corp. v. Smith, 503 U.S. 47 (1992); United States v. Nordic Village, Inc., 503 U.S. 30 (1992); Freytag v. Commissioner, 501 U.S. 868 (1991); Begier v. Internal Revenue Serv., 496 U.S. 53 (1990); United States v. Energy Res. Co., 495 U.S. 545 (1990); United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989); Commissioner v. Asphalt Products Co., 482 U.S. 117 (1987); Commissioner v. McCoy, 484 U.S. 3 (1987).

3 Atlantic Mut. Ins. Co. v. Commissioner, 523 U.S. 382 (1998); Colonial Am. Life Ins. Co. v. Commissioner, 491 U.S. 244 (1989).

4 Boeing Co. v. United States, 537 U.S. 437 (2003); United States v. Int'l Bus. Machines Corp., 517 U.S. 843 (1996).

5 United States v. Fior D'Italia, Inc., 536 U.S. 238 (2002); United States v. Hatter, 532 U.S. 557 (2001); United States v. Cleveland Indians Baseball Co., 532 U.S. 200 (2001); Jersey Shore State Bank v. United States, 479 U.S. 442 (1987).

6 Commissioner v. Banks, 125 S. Ct. 826 (2005); United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001); Gitlitz v. Commissioner, 531 U.S. 206 (2001); Drye v. United States, 528 U.S. 49 (1999); Commissioner v. Estate of Hubert, 520 U.S. 93 (1997); O'Gilvie v. United States, 519 U.S. 79 (1996); Commissioner v. Schleier, 515 U.S. 323 (1995); United States v. Carlton, 512 U.S. 26 (1994); United States v. Irvine, 511 U.S. 224 (1994); Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993); United States v. Hill, 506 U.S. 546 (1993); Commissioner v. Soliman, 506 U.S. 168 (1993); United States v. Burke, 504 U.S. 229 (1992); INDOPCO v. Commissioner, 503 U.S. 79 (1992); United States v. Centennial Sav. Bank FSB, 499 U.S. 573 (1991); Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991); Portland Golf Club v.

This article examines those opinions that address substantive provisions of domestic federal tax law.[7] Because of the number of decisions involved, it is not possible to provide a detailed analysis of each majority decision, much less a detailed analysis of each concurring or dissenting opinion. Nevertheless, this article summarizes the twenty-eight decisions briefly and the current status of each ruling.[8] At the end of each case summary is a reference to other literature that has considered the Court's decision in greater detail.[9]

Most of the opinions reviewed may be divided into a limited number of subject matters. These include the constitutional cases, income cases, deduction cases, corporate tax related cases, and estate and gift tax cases. Within these categories, it is possible to subdivide topics. For example, some of the deduction cases may be grouped as charitable cases and as deduction/capitalization cases. However, the author's attempt to categorize cases, is less than perfect as this article reveals. In particular, some cases involve the alternative minimum tax which raises deduction or income issues. Cases involving income tax accounting could be classified as such, but instead this article discusses those cases on the basis of whether the result affects the time an item of income is reported or an expense is deducted.

II. OVERVIEW OBSERVATIONS

First, when the Court agrees to hear a tax case, it is generally not good news for a taxpayer. The government has been victorious in

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Commissioner, 497 U.S. 154 (1990); Davis v. United States, 495 U.S. 472 (1990); Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990); Hernandez v. Commissioner, 490 U.S. 680 (1989); Commissioner v. Clark, 489 U.S. 726 (1989); South Carolina v. Baker, 485 U.S. 505 (1988); United States v. Wells Fargo Bank, 485 U.S. 351 (1988); Commissioner v. Bollinger, 485 U.S. 340 (1988); Ark. Best Corp. v. Commissioner, 485 U.S. 212 (1988); Commissioner v. Fink, 483 U.S. 89 (1987); United States v. Gen. Dynamics Corp., 481 U.S. 239 (1987); Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[7] The choice to limit the scope of this article is a practical choice and does not necessarily reflect the relative importance of the decisions.

[8] In addition to the twenty-eight Rehnquist Court opinions reviewed, this article reviews two opinions issued by the Court while Rehnquist was still an associate justice: *Jewett v. Commissioner*, 455 U.S. 305 (1982), and *United States v. Am. Bar Endowment*, 477 U.S. 105 (1986). Inclusion of these decisions is necessary for placing the later Rehnquist Court decisions in context.

[9] The reference to the literature is not complete because many of the Court's decisions have been discussed extensively by commentators, but rather is a sampling of applicable articles.

nineteen of the twenty-eight decisions[10] and the taxpayer has prevailed in only nine.[11] The Court affirmed about the same number of lower court decisions as it reversed for the government. The same affirm-to-reverse ratio is true for taxpayer victories and losses. Because nearly all issues heard by the Court resolve conflicts among the circuits, it seems insignificant whether the Court is affirming or reversing the circuit court in a particular case.

Second, when a relatively long-term view is taken of the Supreme Court's tax jurisprudence, one pattern that emerges is the Court's willingness to venture into various areas of tax law and its subsequent willingness to fine tune or provide additional guidance when related

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[10] Wins for the government in which the Court affirmed the lower court's ruling, in part or in its entirety, include:

Drye v. United States, 528 U.S. 49 (1999); O'Gilvie v. United States, 519 U.S. 79 (1996); INDOPCO v. Commissioner, 503 U.S. 79 (1992); United States v. Centennial Sav. Bank FSB, 499 U.S. 573 (1991); Portland Golf Club v. Commissioner, 497 U.S. 154 (1990); Davis v. United States, 495 U.S. 472 (1990); Hernandez v. Commissioner, 490 U.S. 680 (1989); South Carolina v. Baker, 485 U.S. 505 (1988); Ark. Best Corp. v. Commissioner, 485 U.S. 212 (1988). *Jewett v. Commissioner*, 455 U.S. 305 (1982), is discussed in this article, but is a pre-Rehnquist Court decision for the Government that is not included in the totals.

Wins for the government in which the Court reversed the lower court include:

Commissioner v. Banks, 125 S. Ct. 826 (2005); Commissioner v. Schleier, 515 U.S. 323 (1995); United States v. Carlton, 512 U.S. 26 (1994); United States v. Irvine, 511 U.S. 224 (1994); Commissioner v. Soliman, 506 U.S. 168 (1993); United States v. Hill, 506 U.S. 546 (1993); United States v. Burke, 504 U.S. 229 (1992); United States v. Wells Fargo Bank, 485 U.S. 351 (1988); Commissioner v. Fink, 483 U.S. 89 (1987); United States v. Gen. Dynamics Corp., 481 U.S. 239 (1987). United States v. Am. Bar Endowment, 477 U.S. 105 (1986), is discussed in this article, but is a pre-Rehnquist Court decision for the government that is not included in the totals.

[11] Wins for the taxpayer in which the Court affirmed the lower court's ruling in part or in its entirety include:

Commissioner v. Estate of Hubert, 520 U.S. 93 (1997); Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990); Commissioner v. Clark, 489 U.S. 726 (1989); Commissioner v. Bollinger, 485 U.S. 340 (1988); Commissioner v. Groetzinger, 480 U.S. 23 (1987).

Wins for the taxpayer in which the Court reversed the lower court include:

Gitlitz v. Commissioner, 531 U.S. 206 (2001); United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001); Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993); Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991).

issues arise.[12] This trend appears with the damages cases, charitable cases, and disclaimer cases. Third, on rare occasions, the Supreme Court has considered constitutional issues concerning tax statutes.

Fourth, the Court almost always grants certiorari in tax cases rather than hearing a matter as an appeal. Of the cases discussed in this article, only *United States v. Wells Fargo Bank*[13] was heard on appeal; the Court accepted original jurisdiction to hear *South Carolina v. Baker*.[14] For the cases in which certiorari was granted, nineteen were based on conflicting opinions by circuit courts,[15] while only seven were heard because the Court determined the issue was significant or did not otherwise note a conflict in the circuits.[16]

The final and most striking trend that appears is the frequency with which Congress has dealt with the substantive tax issue either by the time the Court makes a decision or shortly thereafter. Thus, a Congressional change in the statutory law moots the Court's opinion. This has occurred in more than half of the Rehnquist Court tax decisions. The discussions below include an epilogue for each of the Court's decisions that describes the ultimate resolution of the issue the Court addressed.

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[12] Because the Court is not a static body that closed down completely when Chief Justice Burger retired and started fresh when Chief Justice Rehnquist was appointed Chief Justice, a few decisions of the Court announced relatively late by the Burger Court are relevant. See, for example, *United States v. Am. Bar Endowment*, 477 U.S. 105 (1986), discussed *infra* Part VI.

[13] *See infra* notes 17–31 and accompanying text.

[14] *See infra* notes 32–44 and accompanying text.

[15] Commissioner v. Banks, 125 S. Ct. 826 (2005); United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001); Gitlitz v. Commissioner, 531 U.S. 206 (2001); Drye v. United States, 528 U.S. 49 (1999); Commissioner v. Estate of Hubert, 520 U.S. 93 (1997); O'Gilvie v. United States, 519 U.S. 79 (1996); Commissioner v. Schleier, 515 U.S. 323 (1995); United States v. Irvine, 511 U.S. 224 (1994); Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993); Commissioner v. Soliman, 506 U.S. 168 (1993); United States v. Burke, 504 U.S. 229 (1992); INDOPCO v. Commissioner, 503 U.S. 79 (1992); Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991); United States v. Centennial Sav. Bank FSB, 499 U.S. 573 (1991); Portland Golf Club v. Commissioner, 497 U.S. 154 (1990); Davis v. United States, 495 U.S. 472 (1990); Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990); Hernandez v. Commissioner, 490 U.S. 680; Commissioner v. Clark, 489 U.S. 726 (1989); Commissioner v. Bollinger, 485 U.S. 340 (1988); Commissioner v. Fink, 483 U.S. 89 (1987); Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[16] United States v. Carlton, 512 U.S. 26 (1994); United States v. Hill, 506 U.S. 546 (1993); Ark. Best Corp. v. Commissioner, 485 U.S. 212 (1988); United States v. Gen. Dynamics Corp., 481 U.S. 239 (1987).

III. Constitutional Issues

The Supreme Court has considered the constitutionality of federal tax statutes on only three occasions and reached the constitutional issue only twice. The Court decided two of the cases in 1988 and the third in 1994. The congressional acts were all found to be constitutional.

A. Estate Tax Exemption for Property Decided

In *United States v. Wells Fargo Bank*,[17] the Court accepted a direct appeal from a California District Court that had ruled certain public housing agency obligations[18] issued by state and local governments were exempt from federal estate taxation. The district court relied on *Haffner v. United States*,[19] which held that Project Notes were exempt from the federal estate tax.

Wells Fargo brought two issues before the Court. First, did the 1937 legislation that authorized the housing agency bonds exempt those bonds from estate taxation? Second, was the 1984 legislation that attempted to deny refunds for estate taxes already paid on the agency bonds constitutional?[20]

The Court first considered the statutory interpretation issue, preferring to reach the constitutional issue if, and only if, the Housing Act of 1937 exempted the bonds from estate taxes.[21] As the Court noted, section 5(e) of that Act provides: "[Project Notes], including interest thereon . . . shall be exempt from all taxation now or hereafter imposed by the United States."[22] An exemption for estate taxes for these notes was supported by the 1937 Senate floor debate regarding the Act. Senator Walsh stated: "[T]he bill gives the public housing agencies the right to issue tax-exempt bonds, which means they are

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[17] 485 U.S. 351 (1988).

[18] The obligations in question were bonds issued by state or local governments under the Housing Act of 1937. United States Housing Act of 1937, ch. 896, 50 Stat. 888.

[19] 585 F. Supp. 354 (N.D. Ill. 1984), *aff'd*, 757 F.2d 920 (7th Cir. 1984).

[20] *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 641, 98 Stat. 939. In addition to denying refunds of estate taxes paid on Housing Project Notes, section 641 also repealed any exemption from estate or gift taxes that might apply to decedents dying after June 19, 1984 or transfers made after that date. *Id.*

[21] United States Housing Act of 1937, ch. 896, 50 Stat. 888.

[22] *Wells Fargo*, 485 U.S. at 355 (alteration in original) (citing the United States Housing Act of 1937).

free from income tax, surtax, estate, gift, and inheritance taxes."[23] In addition, Warren Vinton, who became the Chief Economist of the Housing Authority sometime after the passage of the Housing Act, commented: "Project Notes were 'exempt from all Federal taxes, not only normal income taxes, but surtax, inheritance tax, and gift tax.'"[24]

Notwithstanding the apparent plain meaning of the statutory language, the unequivocal floor debate, and the understanding of a key figure in the post-enactment of the statute, the Court found that the housing notes were not exempt from estate taxes.[25] It dismissed the statement of the Housing Authority official as untimely and found that Senator Walsh misspoke when he described the breadth of the exemption. The Court went on to discount his statement as coming "in the middle of a long speech, [with] no similar expression . . . to be found in any other legislative debate or document."[26]

The Court rejected a plain meaning of the statutory language that "all taxes" means exactly that – all taxes. Instead, the Court concluded that "all taxes" meant only direct taxes, such as income taxes, and did not include excise taxes, such as estate taxes.[27] When Congress intended to exclude property from estate taxes it had been specific.[28] Having determined that the 1937 Housing Act did not exempt the bonds from estate taxation, the Court did not reach the constitutional question of whether Congress could enact this change retroactively.[29]

Epilogue:[30] With the Government win affirming the taxability of the bonds, there has been no Treasury Department or Congressional response to *Wells Fargo*. There was, however, as the Court noted, action by Congress before the Court's decision in *Wells Fargo* to deny refunds for estate or gift taxes already paid. The 1984 corrective legislation also removed the estate and gift exemption on a prospective basis in all events and the constitutionality of that

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[23] *Id.* at 358 (citing 81 CONG. REC. 8085 (1937) (statement of Sen. Walsh)).

[24] *Id.* at 359.

[25] *Id.* at 358.

[26] *Id.*

[27] *See Wells Fargo*, 485 U.S. at 359.

[28] *See id.* at 356 (providing one specific example of such legislative drafting).

[29] *See id.* at 359.

[30] For further discussion of *Wells Fargo,* see Katessa Charles, *The Elimination of Estate Tax Exemption for Project Notes:* United States v. Wells Fargo Bank, 42 TAX LAW. 423 (1989); *Estate and Gift Taxes*, 42 TAX LAW. 1243 (1989).

provision was not before the Court.[31] Thus, the impact of the Court's decision was quite limited.

B. Bearer Bonds may be Taxed as Income

In *South Carolina v. Baker*,[32] an action brought in the original jurisdiction of the Court, South Carolina challenged the constitutionality of section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[33] That section amended Internal Revenue Code (Code) section 103 to add subsection (j)(1), which provided that state and local bond issues are not exempt from federal income taxes unless issued as registered bonds.[34] At Congressional hearings concerning the amendment to section 103, an Assistant Secretary of the Treasury had testified that bearer bonds could be used to avoid income taxes as well as gift and estate taxes.[35] In response to this problem, Congress enacted TEFRA section 310 to require all bonds with a maturity greater than one year to be issued in registered form. Thus, the denial of an income tax exemption for unregistered state and local bonds was just one aspect of the legislation.

In *South Carolina v. Baker*, South Carolina raised a Tenth Amendment argument, asserting that TEFRA section 310 exceeded Congress's authority to regulate the states. The Court found that

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[31] Deficit Reduction Act of 1984, § 641, 98 Stat. 939.

[32] 485 U.S. 505 (1988).

[33] Pub. L. No. 97-248, § 310(b)(1), 96 Stat. 324, 596.

[34] *Id.* Before TEFRA, state and local bonds could be issued in bearer form, that is issued without a registered owner. The Court explained the difference in registered and bearer bonds:

> These two types of bonds differ in the mechanisms used for transferring ownership and making payments. Ownership of a registered bond is recorded on a central list, and a transfer of record ownership requires entering the change on that list. The record owner automatically receives interest payments by check or electronic transfer of funds from the issuer's paying agent. Ownership of a bearer bond, in contrast, is presumed from possession and is transferred by physically handing over the bond. The bondowner obtains interest payments by presenting bond coupons to a bank that in turn presents the coupons to the issuer's paying agent.

Baker, 485 U.S. at 508 (citation omitted).

[35] *See Baker*, 485 U.S. at 509 (citing *Tax Compliance Act of 1982 and Related Legislation: Hearings on H.R. 6300 Before the H. Comm. on Ways and Means*, 97th Cong. 35 (1982) (statement of John Chapoton, Assistant Secretary of the Treasury for Tax Policy)).

argument to be unpersuasive and held that the Tenth Amendment is implicated only when the political process fails; it does not "[authorize] courts to second-guess the substantive basis for congressional legislation."[36]

Next, South Carolina contended that even if the statute were constitutional, TEFRA section 310 "violate[d] the doctrine of intergovernmental tax immunity because it impose[d] a tax on the interest earned on a state bond."[37] This stance was supported by the Supreme Court's 1895 decision in *Pollock v. Farmers' Loan & Trust Co.*,[38] which the *Baker* Court noted had "held that any interest earned on a state bond was immune from federal taxation."[39] The Court responded to this argument by expressly stating that "subsequent law has overruled the holding in *Pollock*."[40] Previously, the Court had ruled that states may tax owners of federal bonds.[41] It held that the federal government may tax the income of those who do business with the states; thus, there is no constitutional prohibition on taxing private citizens on the interest earned from state and local bonds.[42]

Chief Justice Rehnquist and Justices Stevens and Scalia each wrote concurring opinions. Justice O'Connor dissented, arguing that the Tenth Amendment, federalism principles, and *Pollock* all supported the right of the various states to issue bonds without federal regulation. She noted that "[f]ederal taxation of state activities is inherently a threat to state sovereignty," adding, "[a]s Chief Justice Marshall observed long ago, 'the power to tax involves the power to destroy.'"[43]

Epilogue:[44] As one might expect with the Court's decision upholding the constitutionality of the statute, there has been no Treasury

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[36] *Id.* at 513.

[37] *Id.* at 515.

[38] 157 U.S. 429 (1895).

[39] *Baker*, 485 U.S. at 516.

[40] *Id.* at 524.

[41] *See id.* at 526 (discussing *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983)).

[42] *See id.*

[43] *Id.* at 533 (O'Connor, J., dissenting) (citing *McCulloch v. Maryland*, 4 Wheat. 316, 431 (1819)).

[44] For further discussion of *South Carolina v. Baker*, see Brown Wimberly Dennis, Jr., John Story Morgan & Lisa Danean Rountree, Note, South Carolina v. Baker*: Taxing Taxfree Bonds*, 40 MERCER L. REV. 1455 (1989); David M. Richardson, *Federal Income Taxation of States*, 19 STETSON L. REV. 411 (1990).

Department or Congressional response to *South Carolina v. Baker.*

C. Retroactive Legislation is Constitutional

In *United States v. Carlton*,[45] the taxpayer challenged retroactive tax legislation on Fifth Amendment Due Process grounds. In 1986, Congress adopted section 2057, which permitted an estate tax deduction for half of the proceeds from the sale of certain stock to an "employee stock ownership plan" (commonly referred to as an ESOP) by an estate.[46] The statute required the estate to sell the stock before the due date of its estate tax return, but did not require the estate to own the stock before the decedent died.[47] The Omnibus Budget Reconciliation Act of 1987,[48] enacted on December 22, 1987, amended section 2057 retroactively to its original effective date, October 22, 1986, to require that the decedent owned the stock at the time of his or her death.[49]

After the Internal Revenue Service (Service) audited the decedent's estate tax return, it assessed a deficiency for failing to meet the requirements of amended section 2057. Thereafter the decedent's estate paid the asserted deficiency and then sued in district court for a refund, arguing that the retroactive legislation violated the Fifth Amendment's Due Process provision. The district court agreed with the Service's disallowance of the deduction, but the Ninth Circuit reversed.[50] The Supreme Court granted certiorari, without mentioning a conflict among the circuits or any other reason.[51]

At the beginning of its analysis, the Court noted that it had repeatedly sustained retroactive tax legislation.[52] Retroactive tax legislation must pass two tests to satisfy Due Process.[53] First, Congress must not act illegally or arbitrarily.[54] Second, Congress must act promptly to make the retroactive time period modest in length.[55] The estate argued that it had relied detrimentally on the law as

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45 512 U.S. 26 (1994).

46 Tax Reform Act of 1986, Pub. L. No. 99-514, § 1172, 100 Stat. 2085, 2514–15.

47 *Id.*

48 Pub. L. No. 100-203, 101 Stat. 1330-1.

49 *Id.* § 10411, 101 Stat. 1330-432 to -433.

50 Carlton v. United States, 972 F.2d 1051, 1062 (9th Cir. 1992).

51 United States v. Carlton, 510 U.S. 810 (1993).

52 United States v. Carlton, 512 U.S. 26, 29 (1994).

53 *Id.* at 30–32.

54 *Id.* at 32.

55 *Id.*

enacted in 1986. The Court acknowledged that the taxpayer relied on the original statute, but still refused to accept the argument.[56] It reasoned that "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code."[57]

Epilogue:[58] With the Government win affirming Congress's action, there has been no Treasury Department or Congressional response to *Carlton*. It should be noted, however, that because the taxpayer challenged only the retroactive aspect of the 1987 legislation, the power of Congress to prospectively alter the section 2057 deduction was not questioned. Thus, the impact of the Court's decision was limited.

IV. INCOME CASES

A. Security Deposits are Not Income

In *Commissioner v. Indianapolis Power & Light Co.*,[59] the taxpayer required some electric customers with suspect credit to make security deposits. For those customers who established a good credit history with the taxpayer, the deposit was refundable in time or could, at the customer's election, be applied to current electricity charges. Unclaimed deposits escheated to the state after seven years. Deposits held for six to twelve months or more earned interest.[60]

The taxpayer did not treat the deposits as income but instead listed the potential refunds as liabilities in accordance with state regulatory rules. Nevertheless, the deposits were not escrowed or separated in any other way from the taxpayer's other assets. The Service contended that the deposits were income.[61] A unanimous Tax

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[56] *Id.* at 33.

[57] *Carlton*, 512 U.S. at 33 (summarizing the description of the principle asserted by the Court in *Welch v. Henry*, 305 U.S. 134, 146–47 (1938)).

[58] For further discussion of *Carlton*, see Ronald Z. Domsky, *Retroactive Taxation:* United States v. Carlton — *The Taxpayer Loses Again!*, 16 N. ILL. U. L. REV. 77 (1995); Laura Ricciardi & Michael B.W. Sinclair, *Retroactive Civil Legislation*, 27 U. TOL. L. REV. 301 (1996); Matthew D. Slepkow, Note, *Resurrecting the Challenge Against Retroactive Estate Tax Legislation: Acquiescing to the Holding of* United States v. Carlton — *Over My Dead Body*, 3 ROGER WILLIAMS U. L. REV. 119 (1997).

[59] 493 U.S. 203 (1990).

[60] *Id.* at 204–05.

[61] *Id.* at 204–06.

Court agreed with the taxpayer,[62] and the Seventh Circuit affirmed.[63] The Court granted certiorari because of a conflict between the circuits.[64]

The Court began with a restatement of the concessions by both parties: (1) deposits are income if they are advance payments; and (2) security deposits and loans are not income.[65] The Commissioner asserted the security deposits were advance payments, because they secured the payment of electricity to be provided.[66] The taxpayer argued the payments were akin to loans, because the utility was obligated to make refunds with interest if the customer paid for electricity provided by the taxpayer.[67]

The Court noted that both loans and advance payments provide the taxpayer with an economic benefit.[68] Thus, the difference between the two lies in the nature of the rights and obligations which come with the deposit.[69] The difference is not whether the taxpayer has an unrestricted use of the funds as this is true with a loan; rather, it "is whether the taxpayer has some guarantee that he will be allowed to keep the money."[70] An advance payment protects the taxpayer from "the risk that the purchaser will back out of the deal before the seller performs."[71]

Having established the framework for factual analysis, the Court concluded that the taxpayer had no right to the money at the time of deposit, because as of that time, it had sold no electricity to its customer. The fact that the customer later chose to apply the deposit to the payment for electricity did not change the nature of the deposit at the time it was made.[72]

Epilogue:[73] In 1991, the Treasury Department issued Revenue

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62 Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964 (1987).

63 Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162 (7th Cir. 1988).

64 490 U.S. 1033 (1989).

65 Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 207 (1990).

66 *Id.* at 208.

67 *Id.*

68 *Id.*

69 *Id.* at 211 (emphasis in original).

70 *Id.* at 210.

71 *Id.*

72 *Id.* at 211–12.

73 For further discussion of *Indianapolis Power*, see W. Eugene Seago, *Supreme Court Adopts Loan vs. Advance Payment Test for Customer Deposits*, 72 J. TAX'N 204

Procedure 91-31[74] to provide guidance to utilities that had previously been reporting deposits as income. The Revenue Procedure allowed the affected utilities to change their method of accounting for reporting deposits without seeking Service permission for a change in accounting method. Congress did not otherwise alter the result.

B. Corn Products *Revisited*

In *Arkansas Best Corp. v. United States*,[75] the Court revisited its landmark tax opinion in *Corn Prods. Refining Co. v. Commissioner.*[76] Arkansas Best was a diversified holding company that owned approximately sixty-five percent of a Texas bank. From 1969 until 1974, the taxpayer acquired large blocks of shares of the bank, although its ownership percentage did not change significantly. In 1975, the taxpayer sold most, but not all, of its stock in the bank and claimed an ordinary loss of nearly $10 million.[77]

The Commissioner disallowed the taxpayer's ordinary loss deduction, asserting that the loss was in fact a capital loss.[78] The Tax Court agreed with the Commissioner's characterization of the loss attributable to the investments made through 1972 as a capital loss. However, for the loss on the stock acquired after 1972, the Tax Court concluded that the loss was ordinary, because the taxpayer was making additional investments to protect its business reputation.[79]

The Eighth Circuit reversed the portion of the Tax Court's opinion that the post-1972 losses were ordinary.[80] It held that the stock was a capital asset within the meaning of section 1221 and the taxpayer's purpose for acquiring stock was not relevant. The Court granted certiorari without an apparent conflict existing among the circuits.[81]

(1990); George K. Yin, *Of* Indianapolis Power and Light *and the Definition of Debt: Another View*, 11 VA. TAX REV. 467 (1991).

[74] 1991-1 C.B. 566.

[75] 485 U.S. 212 (1988).

[76] 350 U.S. 46 (1955).

[77] *Arkansas Best*, 485 U.S. at 214. From 1969 until 1972, the additional shares were related to the Bank's desire to expand its capital base for growth in its business. In 1972, the Bank's fortunes changed with a downturn in the real estate market and acquisition of additional shares was related to loan portfolio problems. *Id.*

[78] Arkansas Best Corp. v. Commissioner, 83 T.C. 640, 655 (1984).

[79] *Id.* at 656–57.

[80] Arkansas Best Corp. v. Commissioner, 800 F.2d 215, 221 (1986).

[81] *Arkansas Best*, 485 U.S. at 215.

Justice Marshall authored the Court's unanimous opinion that quoted the provisions of section 1221 and noted the taxpayer's argument that *Corn Products* alters the statutory definition of a capital asset. According to the taxpayer, the *Corn Products* doctrine excepts property held with a business purpose from the statutory definition of a capital asset and, therefore, the taxpayer's motive for holding an asset is relevant to determining if it is a capital asset.

Corn Products Refining Company processed raw corn into starch, sugar, and other products. Because of fluctuations in the price and available supply of corn, the company began acquiring corn futures to hedge the market. This assured a steady supply of corn to process and stabilized its costs. When the corn crop was ready for delivery, Corn Products took delivery of some contracted corn and sold the excess contracts.[82] The *Corn Products* Court concluded that the gains the taxpayer realized were ordinary and not capital, even though the futures contracts literally fit the definition of a capital asset. The Court determined that Congress intended for profits related to a taxpayer's business to be taxed as ordinary income.[83]

The *Arkansas Best* Court closely analyzed the business operations of Corn Products Company and deemed the hedging transactions to be an integral part of the company's inventory acquisition system.[84] The futures contracts were not inventory *per se*, but were surrogates for inventory and hardly could be separated from it. In the end, the *Arkansas Best* Court concluded that Corn Products' futures contracts were in fact included in the inventory exception to section 1221.[85]

Having clarified the *Corn Products* decision, the *Arkansas Best* Court concluded that the bank stock was not inventory for the taxpayer who never contended to be a dealer in securities. The Court was uncomfortable that a taxpayer's subjective motive might affect the tax result. Depending on whether the taxpayer wants an asset to be classified as "capital" under section 1221, it might emphasize one motive over another to achieve the desired tax result.[86]

Epilogue:[87] In 1993, the Treasury Department proposed regulations in

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[82] *Id.* at 219.

[83] *Id.* at 219–20 (explaining the reasoning in *Corn Prods. Refining Co. v. Commissioner*, 350 U.S. 46 (1955)).

[84] *Id.* at 220–21.

[85] *Id.*

[86] *Arkansas Best*, 485 U.S. at 222–23.

[87] For further discussion of *Arkansas Best*, see Paul W. Reichel, Note, *When Is*

response to the Court's opinion in *Arkansas Best*, which were finalized in 1994.[88] These regulations provide guidance for business hedging transactions to assure ordinary income treatment. Congress did not alter the result in *Arkansas Best.*

C. Early Withdrawal Penalties are Not Discharge of Indebtedness Income

United States v. Centennial Savings Bank FSB [89] is the companion case to *Cottage Savings,*[90] discussed below in Part VII. In both cases, the Court permitted a loss deduction when one group of mortgages was exchanged for another.[91] Although combined on appeal with *Cottage Savings*, *Centennial Savings* presented a second distinct issue. Some of the taxpayer's customers were prematurely redeeming certificates of deposit, and the taxpayer charged them early withdrawal penalties. Relying on section 108, the taxpayer excluded the penalties from income as discharge of indebtedness income.[92] Both the District Court and the Fifth Circuit agreed with the taxpayer on the issue,[93] and the Court granted certiorari because of a conflict among the circuits.[94]

Justice Marshall, on behalf of the majority, applied a straightforward statutory analysis to conclude that Congress intended section 108 to apply only when the creditor released a debtor from an obligation created at the beginning of the transaction.[95] In *Centennial*, the taxpayer and its depositors negotiated the penalty when the accounts were established, and thus the penalties were not within the exclusion of section 108.[96]

Capital Stock Not a Capital Asset? Definition of a Capital Asset after Arkansas Best Corp. v. Commissioner of Internal Revenue, 41 SYRACUSE L. REV. 831 (1990); Maria E. O'Neill, Note, Arkansas Best Corporation v. Commissioner — *The Demise of the* Corn Products *Doctrine?*, 35 WAYNE L. REV. 1481 (1989).

[88] Treas. Reg. § 1.1221-2 (as amended in 2002).

[89] 499 U.S. 573 (1991).

[90] 499 U.S. 554 (1991).

[91] *See infra* notes 246–270 and accompanying text.

[92] *Centennial Savings*, 499 U.S. at 576.

[93] 682 F. Supp. 1389 (N.D. Tex. 1988), *aff'd*, 887 F.2d 595 (5th Cir. 1989).

[94] 498 U.S. 808 (1990).

[95] *Centennial Savings*, 499 U.S. at 583.

[96] *Id.*

Epilogue:[97] *Centennial Savings Bank* concerned tax year 1981, even though the Court's decision came nine years later. Meanwhile, in 1986, Congress amended section 108 to repeal special treatment for qualified business indebtedness.[98] The legislative change did not directly alter the result in *Centennial Savings Bank*, but it had that effect going forward. It removed the exclusion from income opportunity that the taxpayer sought when it attempted to characterize the early withdrawal penalties as discharge of indebtedness income. Without the repealed exclusion, the classification of the early withdrawal penalties as income is not in doubt.

D. Adjusted Basis Calculations of AMT Purposes

In *United States v. Hill*,[99] an alternative minimum tax (AMT) case, the taxpayers and the Service disputed the correct computation of the taxpayers' adjusted basis in mineral deposits. Under the AMT, the amount a taxpayer's depletion deduction exceeds the adjusted basis in the mineral interest is an item of preference income.[100] The taxpayers included in their adjusted basis the costs of depreciable property[101] used to exploit the mineral deposits – for example, pipes, machinery, and tools – that have not been recovered (deducted) for tax purposes. The Court granted certiorari because of the perceived importance of the issue to federal tax collections.[102]

The Court quickly moved its focus of consideration to the fundamental rule that changes the basis of an asset after acquisition:

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[97] For further discussion of *Centennial Savings*, see Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution,* Macomber, *And Mark to Market*, 13 VA. TAX REV. 1 (1993); James L. Black Jr., Note, *Are Early Withdrawal Penalties Income by Reason of Discharge of Indebtedness?*: United States v. Centennial Savings Bank FSB, 45 TAX LAW. 527 (1992).

[98] Tax Reform Act of 1986, Pub. L. No. 99-514, § 822, 100 Stat. 2085, 2373.

[99] 506 U.S. 546 (1993).

[100] I.R.C. § 57(a)(8) (1954). This provision was amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2333–35, and in amended form is now contained in I.R.C. § 57(a)(1).

[101] I.R.C. § 263(c) (1954) and Treas. Reg. § 1.612-4(c)(1) (1965) differentiated between intangible drilling costs and tangible drilling costs. Intangible costs may be currently deducted but tangible drilling costs are capital items that must be depreciated. Treas. Reg. § 1.612-4(c)(1) has never been amended; I.R.C. § 263(c) has been amended since *Hill* but is materially the same now as it was when the Court rendered its decision.

[102] *Hill*, 506 U.S. at 549.

section 1016.[103] This section controls post-acquisition upward and downward adjustments to a taxpayer's basis of an asset.[104] Within the section framework, the Court reasoned, basis must be determined separately for parts of an asset when sold.[105] For example, when improved real property is sold, the basis of the land is calculated separately from the building because the tax treatment of the disposition of each part is potentially different.[106] Thus, the Court concluded that the tangible drilling costs are separate from the cost of the mineral interest and the two may not be added together when calculating the amount by which the depletion allowance exceeds the taxpayer's basis in the mineral interest.[107]

Epilogue:[108] Section 1915(a) of the Energy Policy Act of 1992[109] amended section 57(a)(1) to remove percentage depletion computed under section 613A as a tax-preference item from AMT calculations. This change exempts independent oil and gas producers, such as the Hills from the AMT, thereby reversing the result in *Hill*. The legislative change did not affect solid mineral producers and integrated producers, however.

V. THE DAMAGES CASES

The most visible example of the Court repeatedly considering the nuances of a recurring tax issue involves taxation of damages. A statutory exclusion for personal injuries damages may be traced to the Revenue Act of 1918.[110] More recently, section 104(a)(2), before amendment in 1989 and again in 1996, excluded "the amount of any damages received (whether by suit or agreement and whether as lump

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[103] *Id.* at 554.

[104] I.R.C. § 1016 (1954); this section is materially the same now as it was when the Court rendered its decision.

[105] *Hill*, 506 U.S. at 557–58.

[106] *Id.*

[107] *Id.* at 559–60.

[108] For further discussion of *Hill*, see Lawrence A. Jegen, III, *U. S. Supreme Court Held That the Adjusted Basis of Taxpayers' Interests In Mineral Deposits Did Not Include Unrecovered Costs of Depreciable Tangible Drilling and Development Costs for Purposes of Calculating Alternative Minimum Tax*, 37 RES GESTAE 482 (1994); *see also* Juli Oh, Note, United States v. Hill*: Limiting the Use of Tangible Costs to Decrease Minimum Tax Burden*, 47 TAX LAW. 1047 (1994).

[109] Pub. L. No. 102-486, sec. 1915(a), 106 Stat. 2776, 3023 (1992).

[110] Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1057, 1066 (1919).

sums or as periodic payments) on account of personal injuries or sickness" from a taxpayer's gross income.[111]

A. Sex Discrimination Award is Gross Income

The Rehnquist Court first addressed the taxation of damages issue when it considered whether back pay awarded in a Title VII sex discrimination was gross income. In *United States v. Burke*,[112] certiorari was granted because of a conflict among the circuits.[113] The taxpayer asserted that section 104(a)(2) excluded monetary damages received as a result of an award for sex discrimination from income because they are "damages received . . . on account of personal injuries or sickness."[114] Thus, the issue was quickly framed as whether sex discrimination was a personal injury. If it was, then authority provided an exclusion from income for damages even though those damages are based on lost income.[115] If sex discrimination is not a personal injury, no exclusion from income exists.

Neither section 104 nor the applicable regulations provide any guidance for the question presented, but the regulations required excludable damages to be paid on account of an "action based upon tort or tort type rights."[116] Thus, the Court reframed the issue as whether a right to recover back pay for sex discrimination based on Title VII of the Civil Rights Act of 1964 is a tort or tort-like claim and thus qualifies for the exclusion from income as personal injury.[117] Essentially the Court determined that it should examine the nature of the claim.

Title VII limits its remedies to "backpay, injunctions, and other equitable relief."[118] No relief is granted for "pain and suffering, emotional distress, harm to reputation, or other consequential damages. . . .[119] With that backdrop, the Court concluded that Title VII damages are not based on tort principles and thus do not qualify

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[111] I.R.C. § 104(a)(2) (1986).

[112] 504 U.S. 229 (1992).

[113] *Id.* at 233.

[114] *Id.* at 232.

[115] *See* Threlkeld v. Commissioner, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

[116] *Burke*, 504 U.S. at 234 (citing Treas. Reg. § 1.104-1(c) (1970)).

[117] *Id.* at 237–38 & n.7.

[118] *Id.* at 238 (citing Civil Rights Act of 1964, Pub. L. No. 88-352, § 706(g), 78 Stat. 241, 261 (1964) (codified as amended at 42 U.S.C. § 2000e-5(g) (2005)).

[119] *Id.* at 239.

for exclusion from income under section 104.[120]

Epilogue:[121] Section 7641 of the Omnibus Budget Reconciliation Act of 1989[122] amended section 104(a)(2) to limit the exclusion from income for certain punitive damages. Only those that relate to physical injuries or sickness are excluded.[123] This change did not *per se* moot the Court's 1992 decision in *Burke* in which the taxpayer was awarded back pay, not punitive damages, as a result of prior discrimination. In 1996, however, Congress again amended section 104(a)(2) in the Small Business Job Protection Act of 1996.[124] This time, Congress removed the exclusion from income for all damages other than those received on account of personal physical injury or physical sickness. Thus, by the 1996 revision, the *Burke* rule was codified.

B. Age Discrimination Award is Gross Income

The next case concerning income taxation of damages that the Court considered was *Commissioner v. Schleier*,[125] an age discrimination case based on the Age Discrimination in Employment Act of 1967 (ADEA).[126] The Tax Court ruled for the taxpayer and the Fifth Circuit affirmed.[127] The Court granted certiorari because of a conflict among the circuits.[128]

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[120] *Id.* at 241–42. Justice O'Connor, in her dissent, argued that the "purposes and operation" of sex discrimination under Title VII are "closely analogous to those of tort law." *Id.* at 249 (O'Connor, J., dissenting). According to Justice O'Connor, the failure of the statute to provide redress for injuries other than back pay is not determinative of the tax consequences. *Id.*

[121] For further discussion of *Burke*, see Mary L. Heen, *An Alternative Approach to the Taxation of Employment Discrimination Recoveries under Federal Civil Rights Statutes: Income from Human Capital, Realization, and Nonrecognition*, 72 N.C. L. REV. 549 (1994); Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not To Tax?*, 2 FLA. TAX REV. 327 (1994).

[122] Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989).

[123] *Id.*

[124] Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996).

[125] 515 U.S. 323 (1995).

[126] Pub. L. No. 90-202, 81 Stat. 602 (1967).

[127] 1993 WL 767976 (T.C. July 7, 1993), *aff'd*, 26 F.3d 1119 (1994), *rev'd*, 515 U.S. 323 (1995).

[128] *Compare* Downey v. Commissioner, 33 F.3d 836 (7th Cir. 1994) (requiring inclusion in gross income of amount received by taxpayer in settlement of litigation under ADEA *with* Schmitz v. Commissioner, 34 F.3d 790 (9th Cir. 1994) (allowing

The Supreme Court looked closely at the tax statute and its requirement that damages be paid "on account of personal injuries or sickness."[129] To illustrate its point about the expansive consequences of adopting the taxpayer's test, the Court provided an example of a taxpayer injured in car accident and who had incurred medical expenses, lost wages, and physical injuries.[130] A settlement of all claims would be excluded from income because the payment for each type of injury resulted from "personal injuries or sickness" within the meaning of section 104.[131]

With this example as a reference point, the Court concluded that the taxpayer's age discrimination cause of action, and the damages she recovered, did not relate to any personal injury.[132] Although the Court conceded that a plaintiff might suffer "some psychological or 'personal' injury"[133] resulting from the discrimination, "[t]he amount of back wages recovered is completely independent of the existence or extent of any personal injury."[134] The Court then stated that "an exclusion from gross income is authorized by the regulation only when it both (i) was received through prosecution or settlement of an action based upon tort or tort type rights . . . and (ii) was received on account of personal injuries or sickness."[135]

The taxpayer in *Schleier* attempted to use the Court's opinion in *Burke* to define age discrimination as a tort or tort-like claim, arguing that *Burke* held that sex discrimination was not a tort or tort-like because these claims did not entitle the plaintiff to a jury trial or liquidated damages.[136] The *Schleier* Court dismissed the argument, ruling that the holding of *Burke* provides that a tort or tort-like recovery requires possible recovery for "traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages.'"[137]

Justice O'Connor dissented in *Schleier*, as she did in *Burke,* and was once again joined by Justice Thomas and picked up the vote of

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exclusion of damages received in settlement of litigation under ADEA from gross income).

[129] *Schleier*, 515 U.S. at 327 (internal quotation omitted).

[130] *Id.* at 329–30.

[131] *Id.*

[132] *Id.* at 330.

[133] *Id.*

[134] *Id.*

[135] *Schleier*, 515 U.S. at 333–34 (internal citations omitted).

[136] *Id.* at 334–35.

[137] *Id.* at 335–36 (quoting United States v. Burke, 504 U.S. 229, 239 (1992)).

Justice Souter. The dissent argued that age discrimination is a "personal injury,"[138] although not a tangible injury, such as physical and mental injuries.[139]

Epilogue:[140] *Schleier* was decided in 1995, the year before Congress finally resolved the damages exclusion.

C. Punitive Damages are Included in Gross Income

The third case in which the Rehnquist Court reviewed the income taxation of damages was *O'Gilvie v. United States*.[141] The Court granted certiorari to consider whether punitive damages awarded as a part of a tort suit are gross income.[142]

In *O'Gilvie*, there was no question that the injuries were personal injuries.[143] The excludability from income of recovery for those injuries turned on the causal relationship required by the statutory condition that recovery be "*on account of* personal injuries."[144] In its two prior decisions, the Court focused on the meaning of "personal injuries."[145] The Court now considered two possible interpretations of the "on account of" phrase. The taxpayers asserted a simple "'but for' connection."[146] All damages awarded in a personal injury lawsuit are on account of the personal injury. If there are no personal injuries, then there are no damages.[147]

The Government argued, however, for more connection between

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138 *Id.* at 337 (O'Connor, J., dissenting).

139 *Id.*

140 For further discussion of *Schleier*, see J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167 (1997); Donald J. Zahn, *Personal Injury Exclusion: Is the Slashing of Wrists Necessary?*, 13 AKRON TAX J. 129 (1997); *see also* the discussion of Congress's post-*Burke* amendment of section 104(a), *supra* notes 122–121 and accompanying text.

141 519 U.S. 79 (1996).

142 *Id.* at 82 (noting that the Fourth, Ninth, Tenth, and Federal Circuits had ruled that punitive damages are income, while the Sixth Circuit excluded punitive damage rewards from income).

143 The plaintiffs were the husband and children of a woman who died of toxic shock syndrome. *Id.* at 81.

144 *Id.* (citing I.R.C. § 104(a)(2) (1988) (emphasis added)).

145 *See* discussions of *Burke* and *Schleier*, *supra* notes 112–145 and accompanying text.

146 *O'Gilvie*, 519 U.S. at 82.

147 *Id.*

the personal injuries and the damages awarded.[148] In the case of punitive damages, the award does "not compensate for any kind of loss."[149] Rather, punitive damages are awarded because of "a defendant's reprehensible conduct and the jury's need to punish and to deter it."[150] The majority of the Court preferred the government's interpretation of the statute. It found the taxpayers' statutory interpretations, policy arguments, and view of legislative history unpersuasive. Moreover, the majority argued that its prior opinion in *Schleier* came close to resolving the issue. In *Schleier*, the Court ruled that age discrimination damages "are not 'designed to compensate ADEA victims,' . . . instead they are 'punitive in nature.'"[151] This view of its prior opinion buttressed the *O'Gilvie* Court's conclusion that punitive damages are not "damages received . . . on account of" the plaintiff's personal injury.[152]

In a lengthy dissent, Justice Scalia, joined by Justices O'Connor and Thomas, rejected the majority's reading of the statute. Section 104(a)(1) limits the exclusion for workmen's compensation awards to "'compensation for' personal injuries or sickness."[153] By contrast, section 104(a)(2) excludes "any damages received . . . *on account of* such [personal] injuries or sickness."[154] The dissent found that the difference in legislative drafting clearly indicated a Congressional intent to tax the damages of the two types of injuries differently.

Epilogue:[155] Congress amended section 104 in the Small Business Job Protection Act of 1996,[156] which was enacted on August 20, 1996. In this amendment, Congress removed the exclusion from income for all

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[148] *Id.* at 83.

[149] *Id.* at 86–87.

[150] *Id.* at 83.

[151] *Id.* at 84 (quoting *Commissioner v. Schleier*, 515 U.S. 323, 332 (1995)) (citations omitted).

[152] *Id.*

[153] *O'Gilvie*, 519 U.S. at 95 (Scalia, J., dissenting) (quoting I.R.C. § 104(a)(1) (1988)).

[154] *Id.* at 96 (Scalia, J., dissenting) (quoting § 213(b)(6) of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1065–66) (emphasis in original)).

[155] For further discussion of *O'Gilvie*, see Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447 (1998); *see also* F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725 (1997).

[156] Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996).

damages other than those directly received on account of personal physical injury or physical sickness not to include punitive damages in those instances. This amendment was enacted nearly two months before the Court heard oral arguments and nearly four months before the Court rendered its opinion in *O'Gilvie*.[157]

D. Legal Fees are Gross Income

A fourth damages opinion, *Commissioner v. Banks*,[158] did not focus on the exclusion from income for a damages award under section 104(a)(2). Rather, it considered whether the portion of a damages award paid to a plaintiff's attorney is included in the plaintiff's gross income.[159] The issue was tax-meaningful under the AMT rules, because if the portion of the award to the attorney is included in the gross income of the plaintiff, the AMT effectively taxes the plaintiff on the monies paid to his or her attorney because no deduction is permitted for that tax computation.[160]

Banks and *Banaitis v. Commissioner*,[161] which was consolidated with *Banks* on appeal, concerned taxpayers who had settled employment-related complaints with their former employers.[162] The unanimous majority concluded that the amount paid to the attorney out of the settlement proceeds by the taxpayer was an anticipatory assignment of income by the taxpayer.[163] Although the taxpayer did not have dominion and control over the income when paid, the taxpayer had control over the asset which produced the income and

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[157] *See supra* note 124 and accompanying text.

[158] 125 S. Ct. 826 (2005). It should be noted that Chief Justice Rehnquist took no part in the decision in *Banks*.

[159] *Id.* at 826–27.

[160] The alternative minimum tax eliminates miscellaneous itemized deductions for expenses. Thus, even if the amount paid for legal fees from a damages settlement is deemed a deductible expense, a taxpayer paying the alternative minimum tax would not be permitted to deduct that amount from his alternative minimum taxable income. The calculation of the taxpayer's liability under the alternative minimum tax would include the amount paid to the attorney, and thus the taxpayer would in effect pay taxes on the entire amount received in the settlement.

[161] 340 F.3d 1074 (9th Cir. 2003).

[162] *Banaitis* arose out of the taxpayer's settlement with his former employer of claims for (1) wrongful discharge and (2) interference with his employment by a corporation that acquired his employer. *Id.* at 1077–78. The attorney's fees in *Banks* came from a settlement of an employment discrimination action. *Banks*, 125 S. Ct. at 826.

[163] *Banks*, 125 S. Ct. at 831.

that was sufficient to invoke the doctrine.[164]

Epilogue:[165] The AMT issue raised by legal fees paid was partially resolved by Congress after the Court granted certiorari in *Banks*, but before the Court rendered its decision.[166] Section 703 of the American Jobs Creation Act of 2004, which amended section 62(a)(20), now provides that a deduction from gross income for attorney fees and court costs paid in connection with any action for unlawful discrimination up to the amount of the judgment or settlement that is included in gross income.[167]

While this section renders moot the ruling in *Banks*, it does not reverse *Banks* in matters in which legal fees are paid for reasons not covered by section 62(a)(20). In particular, legal fees associated with punitive damages are not covered by the new statute. Thus, as a result of *Banks* and *O'Gilvie*, a taxpayer with a contingent fee will pay alternative minimum taxes on one hundred percent of punitive damages received, while netting less because of legal fees and other litigation expenses paid from punitive damages award.

VI. CHARITABLE DEDUCTION CASES

A. Excess Insurance Costs Not a Charitable Deduction for ABA Members

United States v. American Bar Endowment,[168] decided while Rehnquist was still an associate Justice,[169] involved taxpayers[170] who claimed charitable deductions for amounts paid for insurance premiums that allegedly cost more than market rates for similar

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164 *Id.* at 831–32.

165 For further discussion of *Banks*, see D. Michael O'Leary, *Supreme Court Agrees with IRS on Contingent Attorney Fee Cases*, 79-JUN FLA. B.J. 75 (2005).

166 Certiorari was granted on March 29, 2004. 541 U.S. 958 (2004). The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), was enacted on October 22, 2004. The Court heard oral arguments on November 1, 2004, and rendered its opinion on January 24, 2005. *Banks*, 125 S. Ct. at 826.

167 Pub. L. No. 108-357, § 703, 118 Stat. at 1546–47.

168 477 U.S. 105 (1986).

169 This is one of two Burger Court decisions reviewed in this article because of the Rehnquist Court's heavy reliance on it. The other Burger Court decision is *Jewett*. *See infra* notes 383–393 and accompanying text.

170 *Am. Bar Endowment* was combined on appeal with the cases of several individual taxpayers who had purchased insurance from the Endowment and claimed charitable contributions for a portion of their premium payments. *Id.* at 108–09.

insurance.[171] The Endowment asserted that its profits were charitable contributions for taxpayers who purchased insurance from it. The factual record indicated that the taxpayers were not paying more for insurance coverage through the American Bar Endowment than they would for similar coverage from other sources.[172]

The Court held that a charitable deduction is only permitted when the amount paid to the charitable organization exceeds the value of the benefit received. It cited favorably the two-part test of Revenue Ruling 67-246, which permits charitable deductions when the payment to the charity exceeds the value of the benefit received and the donor intends to make a charitable gift.[173] Most of the individual taxpayers in the lawsuit failed the first test because the payment did not exceed the cost of similar insurance coverage.[174] One of the taxpayers passed the first test but failed the second, because he was not aware of the less expensive coverage until after the payments in controversy were made.[175]

Epilogue:[176] After the Court's decision, the American Bar Endowment altered its procedures to qualify a portion of the premium payments for charitable deductions. Under the agreement between the Endowment and the Service, each insurance purchaser is given notice to demand a refund of the excess cost within a limited amount of time each year.[177] With that change in its procedures, the American Bar Endowment satisfied the Service on the qualification of the charitable contribution.

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[171] *Id.* at 108. The decision also considered the issue of whether the profits of the Endowment were "unrelated business income" and subject to the unrelated business income tax of Code sections 511–513. *Id.* at 106.

[172] *Am. Bar Endowment*, 477 U.S. at 116.

[173] *Id.* at 117 (citing Rev. Rul. 67-246, 1967-2 C.B. 104).

[174] *Id.*

[175] *Id.* at 117–18.

[176] For further discussion of *Am. Bar Endowment*, see Lisa Huettner Dolan, Note, *Charitable Donations or Unrelated Business Income?:* United States v. American Bar Endowment, 21 U.S.F. L. REV. 817 (1987); Angela M. Donovan, Note, *Fund-Raising or Unrelated Business? Tax Consequences for Exempt Organizations and Contributors:* United States v. American Bar Endowment, 40 TAX LAW. 395 (1987).

[177] Given its particular facts, I.R.S. Priv. Ltr. Rul. 87-25-056 (Mar. 25, 1987) probably is the agreement between the Internal Revenue Service (Service) and the Endowment.

B. Scientologist Denied Deduction for Fees Paid

In *Hernandez v. Commissioner*,[178] the taxpayers[179] deducted amounts paid to the Church of Scientology as section 170 charitable contributions. All payments were for training[180] or one-on-one sessions called auditing.[181] The Church charged a set price for each session. The fees paid were the Church's primary source of income. The Church offered discounts for prepaid fees and generally gave refunds for unused portions of fees.[182] The Commissioner conceded that the Church was a qualified charity entitled to receive tax deductible contributions. With this concession, the Court concluded that the issue was narrowly framed as whether auditing and training fees are charitable contributions deductible under section 170.[183] The Court granted certiorari because of a conflict among the circuits.[184]

The Court quoted favorably the Tax Court's decision in *Graham v. Commissioner,*[185] which concluded that a section 170 charitable contribution means a gift or "a *voluntary transfer* of property . . . *without consideration* therefor."[186] Thus the question was stated as "whether petitioners' payments for auditing and training sessions are 'contribution[s] or gift[s]' within the meaning of § 170."[187]

The majority reviewed the limited legislative history of section 170 and affirmed the no "quid pro quo" rule of the lower courts; for example, payments to a charitable hospital are not charitable contributions if made for medical treatment.[188] *Hernandez* was similar

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[178] 490 U.S. 680 (1989).

[179] Two cases were combined on appeal: *Hernandez v. Commissioner*, 819 F.2d 1212 (1st Cir. 1987), and *Graham v. Commissioner*, 822 F.2d 844 (9th Cir. 1987).

[180] Training involves the study of the tenets of Scientology and leads to qualification as auditors. *Hernandez*, 490 U.S. at 685.

[181] These sessions are also called "'processing,' 'counseling,' and 'pastoral counseling.'" *Id.* at 684 n.2.

[182] *Id.* at 685–86.

[183] *Id.* at 686–89.

[184] The First, Fourth, Ninth and Tenth Circuits found for the government, while the Second and Eighth Circuits found for the taxpayer.

[185] 83 T.C. 575 (1984).

[186] *Hernandez*, 490 U.S. at 687 (emphasis in original) (quoting *Graham*, 83 T.C. at 580).

[187] *Id.* at 690 (alterations in original).

[188] *Id.* (quoting S. REP. NO. 83-1622, at 196, *reprinted in* 1954 U.S.C.C.A.N. 4621, 4831, and H.R. REP. NO. 83-1337 at A44, *reprinted in* 1954 U.S.C.C.A.N. 4017, 4044–45).

to the Court's prior opinion in *American Bar Endowment*,[189] discussed above, in which taxpayers claimed charitable deductions for amounts paid for insurance premiums that were allegedly higher than market rates. In *American Bar Endowment*, the Court upheld the Commissioner's disallowance, because the taxpayers did not prove that they were aware of lower cost insurance at the time of purchase, and therefore could not establish that the transaction was other than a quid pro quo.[190] When that principle was applied to *Hernandez*, the charitable deduction failed because a set price was established for the auditing and training courses.[191]

The majority rejected the taxpayers' argument that quid pro quo is not the appropriate analysis when the benefit received is entirely religious in nature.[192] It believed that the taxpayers' position would open the charitable deduction for tuition to parochial schools, payments for counseling sessions sponsored by a church, or medical treatment received at a hospital.[193] Finally, the Court rejected a claim that the Commissioner's long standing administrative policy allowed deductions of payments associated with religious activities such as pew dues and tickets to Jewish High Holy Day events.[194] This final argument was not considered on its merits, because the Court concluded that the record at trial on this issue was not complete.[195]

A well-reasoned dissent by Justice O'Connor, who was joined by Justice Scalia, argued that the Commissioner was not consistent in his treatment among various religions and cited Revenue Ruling 70-47[196] and its allowance of a deduction for pew dues and other payments to religious charities in which something was received in exchange.[197] Moreover, the dissent believed that it was possible to permit a deduction for the portion of a payment that exceeded the value of the quid pro quo. Justice O'Connor illustrated the potential with an example of a $1,000 ticket to a charity dinner when the value of the

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189 477 U.S. 105 (1986); *see supra* notes 168–176 and accompanying text.

190 *Hernandez*, 490 U.S. at 691.

191 *Id.*

192 *Id.* at 692.

193 *Id.* at 693. The majority also rejected constitutional arguments "based on the Establishment Clause and the Free Exercise Clause of the First Amendment." *Id.* at 694. Examination of these arguments is beyond the scope of this article.

194 *Id.* at 701–02 (citing Rev. Rul. 70-47, 1970-1 C. B. 49 (authorizing charitable deductions for pew rents, building fund assessments, and periodic dues)).

195 *Id.* at 702–03.

196 1970-1 C.B. 49.

197 *Hernandez*, 680 U.S. at 708 (O'Connor, J., dissenting).

food is only $50.[198]

Epilogue:[199] Since *Hernandez* was decided, the media reports that the Service and the Church of Scientology have settled their dispute and a tax deduction is permissible for auditing and training sessions.[200] The Service, in Revenue Ruling 93-78,[201] announced that Revenue Ruling 78-189[202] was obsolete. The 1978 ruling set out the Service's disallowance for Scientology auditing and training sessions. The 1993 ruling did not specifically authorize a deduction, however. A Westlaw® search does not yield a published position on this issue other than Revenue Ruling 93-78. Alison Eaton, in a law review article, provides much greater detail concerning the Service's alleged reversal of Hernandez.[203] *Sklar v. Commissioner*, a case involving an attempt to deduct the cost of tuition for the taxpayers' children to attend religious schools, reports the Service's refusal to disclose any "deal" with the Scientologists.[204]

C. Direct Support of Children Serving as Missionaries Not Deductible

In *Davis v. United States*,[205] the taxpayers provided direct financial support to their adult children when the children were serving as missionaries for the Church of Jesus Christ of Latter-day Saints. The direct support was consistent with church policies and procedures that expected the parents of missionaries to subsidize the cost of their children serving the church in the mission fields.[206] Benefits to the church included reduced bookkeeping and administration, among

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198 *Id.* at 706 (O'Connor, J., dissenting).

199 For further discussion of *Hernandez*, see *Religious Payments as Deductible Charitable Contributions*, 103 HARV. L. REV. 361 (1989); *see also* Daniel Rattin Mitz, Note, *Save Your Local Church or Synagogue: When are Taxpayer Contributions to Religious Organizations Deductible Under Section 170?*, 63 N.Y.U. L. REV. 840 (1988). For more on the Service's alleged reversal of the position taken in *Hernandez*, see Alison Eaton, Comment, *Can the IRS Overrule the Supreme Court?*, 45 EMORY L.J. 987 nn.2–17 and accompanying text (1996).

200 Elizabeth MacDonald, *Scientologists and IRS Settled for $12.5 Million*, WALL ST. J., Dec. 30, 1997, at A12.

201 1993-2 C.B. 75.

202 1978-1 C.B. 68.

203 *See* Eaton, *Can the IRS Overrule the Supreme Court*, 45 EMORY L.J. 987 nn.2–17 and accompanying text (1996).

204 282 F.3d 610, 614–15 (9th Cir. 2002).

205 495 U.S. 472 (1990).

206 *Id.* at 474.

other things.[207] The Court granted certiorari because of a conflict among lower courts.[208]

The church established the amount parents were to provide each child for living expenses such as rent, transportation, and food.[209] The church regulated the activities of the missionaries and group leaders submitted weekly expense reports.[210] When it deemed appropriate, the church altered the amount supplied by the parents to missionary-children.[211] On amended income tax returns, the taxpayers claimed tax refunds for the money given to their children for mission field expenses as section 170 charitable deductions. The Service denied the refund claims.[212]

Section 170 permits a charitable deduction for amounts given "to or for the use of" qualified charities.[213] In the litigation, the taxpayers conceded that their transfers to their children were not "to" a qualified charity, but asserted that the amounts given were "for the use of" a qualified charity.[214] The Court conceded that the phrase "for the use of" could be interpreted broadly as suggested by the taxpayers.[215] However, the phrase could also be narrowly interpreted to mean "in trust for" the charity as the Service argued.[216]

To resolve the disagreement, the Court reviewed the legislative history of section 170. The original version of section 170 did not include the phrase "for the use of" but instead permitted deductions only for gifts "to" qualified charities.[217] However, in 1921, Congress amended the predecessor to section 170 to permit deductions for gifts "for the use of" charities in response to requests to permit deductions to "charitable trusts, charitable foundations, or community chests."[218] Next, the Court considered the historical meaning of the word "use." It determined that the English common law meaning of "use" is

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[207] *Id.*

[208] *Id.* at 476–77.

[209] *Id.*

[210] *Davis*, 495 U.S. at 475.

[211] *Id.*

[212] *Id.* at 476–77.

[213] I.R.C. § 170(c) (1982).

[214] *Davis*, 495 U.S. at 477.

[215] *Id.* at 479.

[216] *Id.*

[217] *Davis*, 495 U.S. at 479–80 (citing the War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330).

[218] *Id.* at 480 (citing the Revenue Act of 1921, ch. 136, § 214(a)(11), 42 Stat. 227, 241).

similar to a trust.[219] Finally, the Court considered the fact that the Service had adopted the limited "trust" interpretation of the "for the use of" phrase soon after the 1921 amendment to section 170 persuasive.[220] The administrative interpretation does not carry the same weight of authority as a regulation, but still carries considerable weight.[221]

Ultimately, the Court held that the taxpayers' transfers were not transfers "'in trust for' the Church."[222] Only by making gifts to a trust for the church or some other "enforceable legal arrangement for the benefit of the church" could taxpayers satisfy section 170.[223]

Epilogue:[224] After *Davis*, the Church of Jesus Christ of Latter-day Saints changed its policies and procedures to permit parents of missionaries and other donors to transfer funds to the Church to support missionaries.[225] Based on the new procedures, the Service concluded that gifts to support missionaries would satisfy the requirements of section 170 except "if an investigation should uncover facts which affirmatively establish that the Church does not control the expenditure of the donations or that a commitment or understanding exists at the time of contribution that the funds will be spent for the benefit of a particular missionary . . . ."[226] Thus, as in the aftermath of the *Hernandez* decision, the Court's ultimate role was to set the subsequent terms for compromise between the taxpayer and the Service.

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[219] *Id.* at 481–82.

[220] *Id.*

[221] *Id.* at 484.

[222] *Id.* at 486.

[223] *Davis*, 495 U.S. at 486.

[224] For further discussion of *Davis*, see Joel S. Newman, *A Proposal for Direct, Deductible Charitable Contributions*, 96 DICK. L. REV. 209 (1992); Richard A. Leavitt, Casenote, *When is a Gift to the Minister Not a Gift to the Church? — The Impact of* Davis v. United States *on Charitable Giving*, 66 TUL. L. REV. 245 (1991).

[225] I.R.S. Litig. Guide. Mem. TL-34 (Rev), 1993 WL 1470341 (Apr. 23, 1993) (describing in detail the new procedure called "equalized funding approach" for financing the cost of missionaries).

[226] *Id.*

VII. OTHER PERSONAL DEDUCTION CASES

A. Trade or Business Clarified

In *Commissioner v. Groetzinger*, the Court considered whether a professional gambler was in a trade or business even though he did not sell goods or services to customers.[227] While the Court focused on whether the taxpayer's losses qualified as section 162 trade or business expenses, the underlying issue arose under the AMT regime. Section 162 deductions reduce AMT income, but ignore gambling losses for the tax year in question that are not connected with a trade or business.

In its 1940 opinion in *Deputy v. DuPont*, the Court considered whether certain expenses of the taxpayer met the requirement of the predecessor of section 162.[228] Ultimately, the Court decided the expenses did not satisfy the ordinary and necessary requirement of the deduction.[229] Justice Frankfurter, in a concurring opinion, questioned whether the taxpayer was in a trade or business because he deemed it necessary for the taxpayer to sell goods or services to others to satisfy the requirement for a trade or business deduction.[230] Frankfurter's goods or services test presented the taxpayer in *Groetzinger* with a substantial hurdle because he gambled only for his own account. The taxpayer did not satisfy the goods or services test of *DuPont* despite betting on dog races six days a week, forty-eight weeks a year.

The Court reviewed its own precedent and concluded that Frankfurter's goods or services requirement was judicial gloss that had never "achieved the status of a Court holding."[231] With that potential precedent side-stepped, the Court concluded that the taxpayer was in a trade or business.[232] A three-Justice dissent argued that gambling for one's own account was not a trade or business.[233]

Epilogue:[234] In 1982, years before the Court granted certiorari in

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[227] 480 U.S. 23 (1987).

[228] 308 U.S. 488 (1940).

[229] *Id.* at 497.

[230] *Id.* at 499 (Frankfurter, J., concurring).

[231] *Groetzinger*, 480 U.S. at 32.

[232] *Id.* at 35.

[233] *Id.* at 37 (White, J., dissenting).

[234] For further discussion of *Groetzinger* see Jerald David August and Steven J. Levine, *Goods and Services Test for Trade or Business Rejected by Supreme Court*, 66 J. TAX'N 298 (1987); *see also* Andrew M. Curtis, Commissioner v. Groetzinger —

Groetzinger, Congress amended the AMT rules to permit a deduction for gambling losses.[235] The amended AMT rules applied to tax years beginning in 1983 and later.[236] Thus, by the time *Groetzinger* was decided, its holding had been superseded by statute four years earlier.

B. Profit Motive Required

In *Portland Golf Club v. Commissioner*,[237] the taxpayer was a social club that sought to deduct expenses associated with non-members to offset investment income.[238] The circuit court ruled that the taxpayer could use the expenses in excess of non-member income to reduce investment income only if sales to non-members were done with a profit motive. The Supreme Court granted certiorari because of a conflict among the circuits.[239]

The real question involved in *Portland Golf* was the method to be used to compute the taxpayer's intent to make a profit. Specifically, should the taxpayer's indirect or fixed costs reduce receipts from non-members to determine a profit motive?[240] When computing a loss from non-member sales, the taxpayer included indirect costs in the computation, but when determining its profit motive, the taxpayer excluded indirect costs. The Supreme Court agreed with the Service that the same method of accounting must be used for both computations.[241]

Epilogue:[242] In Announcement 90-138,[243] the Service reaffirmed its

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Supreme Court Holds that the 'Goods or Services' Test is not a Prerequisite to 'Trade or Business' Status, 22 WAKE FOREST L. REV. 221 (1987).

[235] Tax Equity and Fiscal Responsibility Act of 1982, § 201(a), 96 Stat. 324, 411–14 (amending Code section 55(e)(1)(A).

[236] According to the dissenters, the 1982 amendment made it clear that Congress did not intend gambling to be a trade or business and the statutory change did not make gambling a trade or business for the purposes of section 162. Rather, the change provided equitable relief from an unfair imposition of the alternative minimum tax. *Groetzinger*, 480 U.S. at 37–38 (White, J., dissenting).

[237] 497 U.S. 154 (1990).

[238] Receipts from members were exempt from the social club's income under section 501(c)(7). I.R.C. § 501(c)(7) (1990). However, the club's investment income was taxable under section 512(a)(3)(A). *Portland Golf Club*, 497 U.S. at 161 n.11.

[239] *Portland Golf Club*, 497 U.S. at 160.

[240] *Id.* at 164–65. Indirect costs are general overhead items, costs the taxpayer would incur if it had no sales to non-members.

[241] *Id.* at 171.

[242] For further discussion of *Portland Golf* see Carolyn P. Chiechi & Jeffrey W.

position in Revenue Ruling 81-6[244] and instructed its field offices to complete the cases suspended pending the Court's decision in *Portland Golf.* Moreover, the Service warned social clubs that it would be "[c]losely monitoring the return filing patterns of section 501(c)(7) organizations. It will be doing this to see if social clubs are filing amended Form 990-T returns where necessary and to identify those clubs for examination that should be filing Form 990-T returns and that are not currently doing so."[245]

C. Exchange of Mortgages is Loss Recognition Event

In *Cottage Savings Ass'n v. Commissioner*,[246] the taxpayer sold participation interests in a group of mortgages it owned and, simultaneously, bought about the same value of participation interests in another group of mortgages from its buyer.[247] The taxpayer represented to the Federal Home Loan Bank Board that the mortgages exchanged were "substantially identical."[248] On its 1980 income tax return, the taxpayer claimed a loss for the difference between the value and the face amount of the loans it exchanged.[249] The Tax Court allowed the loss deduction,[250] but the Sixth Circuit reversed, holding that the loss was not sustained under the rules of section 165(a).[251] The Court granted certiorari because of the importance of the issue to the savings and loan industry and because of a conflict among the circuits.[252]

Munk, *When Can Social Clubs Offset Investment Income with Losses from Nonmember Activities?*, 73 J. TAX'N 184 (1990); Karen L. Conant, Note, *Tax Exempt Social Clubs Must Use Consistent Accounting Methods:* Portland Golf Club v. Commissioner, 44 TAX LAW. 1165 (1991).

243 1990-51 I.R.B. 38.

244 1981-1 C.B. 351.

245 I.R.S. Announcement 90-138, 1990-51 I.R.B. 38.

246 499 U.S. 554 (1991).

247 A participation interest in a mortgage is a partial interest in the instrument held along with other lenders.

248 *Cottage Sav.*, 499 U.S. at 557 (citing Federal Home Loan Bank Board, Memo. R-49 (June 27, 1980)).

249 *Id.* at 558.

250 90 T.C. 372 (1988).

251 Cottage Sav. Ass'n v. Commissioner, 890 F.2d 848, 855 (6th Cir. 1989).

252 *Cottage Sav.*, 499 U.S. at 558 (referring to *Cottage Sav.*, 890 F.2d 848 (disallowing the loss deduction); Fed. Nat'l Mortgage Ass'n v. Commissioner, 896 F.2d 580 (D.C. Cir. 1990) (allowing the loss deduction); San Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577 (5th Cir. 1989) (same)).

Section 1001 provides that a taxpayer recognizes a gain or loss only when a disposition of property occurs; however, mere fluctuations in value are not income or deductions.[253] Therefore, the Commissioner framed the issue as whether there was an exchange of materially different property within the section 1001 context.[254] The taxpayer countered that any exchange of property is a disposition or, in the alternative, the exchange it entered into was materially different because the security for the various loans all differed.[255]

The Commissioner argued that the properties were "materially different" only if they "differ in economic substance."[256] The Commissioner's position was not supported by Treasury Regulations, and thus the Court resorted to case law to define "materially different." That inquiry led first to a classic case in early tax controversy, *Eisner v. Macomber*.[257] This Court decision dealt with "realization" under section 1001 and held that a pro rata stock dividend was not income.[258] Three additional Court decisions involving exchange of corporate stock in reorganizations refined the *Macomber* principle.[259] Two of these transactions were realization events because the corporations changed domicile,[260] while the third was not because the new corporation was in the same state.[261] From these cases the Court gleaned a rule that realization occurs when "the property entitlements are not identical."[262] The Court also noted that the statute itself supported this reading of section 1001, under which dispositions of property are recognized unless one of the statutory exceptions specifically applies.[263] Section 1031 provides for nonrecognition of realized gains and losses when property of like kind is exchanged. The Court reasoned that section 1031's nonrecognition rule would not be necessary if exchanging similar property did not result in a realization event.[264]

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253 I.R.C. § 1001 (1991).

254 *Cottage Sav.*, 499 U.S. at 562.

255 *Id.* at 560.

256 *Id.* at 562–63.

257 252 U.S. 189 (1920).

258 *Id.* at 212.

259 Marr v. United States, 268 U.S. 536 (1925); Weiss v. Stearn, 265 U.S. 242 (1924); United States v. Phellis, 257 U.S. 156 (1921).

260 *Marr*, 268 U.S. at 541–42; *Phellis*, 257 U.S. at 173.

261 *Weiss*, 265 U.S. at 252–54.

262 *Cottage Sav.*, 499 U.S. at 565.

263 *Id.* at 566.

264 *Id.*

A dissent written by Justice Blackmun, and joined by Justice White, argued that the exchange of mortgages was not material.[265] The Federal Home Loan Bank Board in Memorandum R-49 permitted non-reporting for exchanges of "substantially identical" mortgages.[266] The memorandum noted that the purpose of the exchanges was to generate tax losses for savings and loans without substantially altering the economic situation of the institutions. The dissent "found it surprising that an agency not responsible for tax matters" would weigh in on the tax consequences of the transaction.[267] The dissent and the majority agreed the mortgages differed, but the dissent did not believe that the difference was "material."[268] The ruling of the Federal Home Loan Bank Board held the exchanged mortgages were "substantially identical."[269]

Epilogue:[270] In response to *Cottage Savings*, the Treasury Department issued proposed regulations under section 1001 that were finalized in 1996.[271] The regulations provide clear guidance, including a number of examples on when modifications of debt instruments and loans will tax recognition events.

D. Accrual Accounting – All Events Test Clarified

In *United States v. General Dynamics Corp.*,[272] the Court considered whether the "all events" deduction test of section 461 had been met to allow the taxpayer to deduct expenses related to its employee medical care plan.[273] For an employee to receive a plan benefit, it was necessary for the employee to file a claim form. The reimbursement request was then sent to a plan administrator for

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[265] *Id.* at 569 (Blackmun, J., dissenting).

[266] *Id.* at 557.

[267] *Id.* at 569 (Blackmun, J., dissenting).

[268] *Id.* at 571 (Blackmun, J., dissenting).

[269] *Id.*

[270] For further discussion of *Cottage Savings*, see Thomas V. Glynn, *Financing Real Estate Transactions — Current Developments*, 55 N.Y.U. ANN. INST. ON FED. TAX'N §§ 13.01, 13.02[1][a][i], at 13–16 (1997); Richard H. Nicholls, Cottage Savings: *More S&L Problems?*, 45 TAX LAW. 727 (1992); Loren D. Prescott, Jr., Cottage Savings Association v. Commissioner: *Refining the Concept of Realization*, 60 FORDHAM L. REV. 437 (1991).

[271] Treas. Reg. § 1.1001-1(3)(c) (2005).

[272] 481 U.S. 239 (1987).

[273] *Id.* at 242–43 (citing Treas. Reg. § 1.461-1(a)(2) (1986)).

processing. The Court granted certiorari without an apparent conflict existing in the circuits.[274]

In analyzing the issue, the Court summarily reviewed several of its prior opinions, most notably its opinion in *United States v. Hughes*,[275] which had been decided in the prior term.[276] The "all events" test set out in Treasury Regulations provided that "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."[277] The Court determined that an employee's incurrence of medical expenses was not the last event to establish the taxpayer's liability.[278] Rather, the last event was the employee filing a claim for reimbursement; for various reasons, some employees will not file claims and the taxpayer will not make those reimbursement payments.[279]

Justice O'Connor, joined by Justices Blackmun and Stevens, dissented. They argued that the obligation to pay valid claims arose when the medical services were provided.[280] In supporting their conclusion, they pointed to other instances where the Court would allow deductions for expenses that might not be paid, including a taxpayer filing for bankruptcy before paying an accrued debt and a check not being cashed.[281]

Epilogue:[282] No legislation or regulations have altered this decision.

E. The Home Office Deduction Denied

In *Commissioner v. Soliman*,[283] the taxpayer was an anesthesiologist at three hospitals in the Washington, D.C. area.

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[274] *Id.* at 242.

[275] 476 U.S. 593 (1986).

[276] *Hughes* was a Burger Court decision and thus not reviewed in this article.

[277] *General Dynamics*, 481 U.S. at 243 (citing Treas. Reg. § 1.461-1(a)(2) (1986)).

[278] *Id.* at 244–45.

[279] *Id.* at 244.

[280] *Id.* at 248–49 (O'Connor, J., dissenting).

[281] *Id.* at 249 (O'Connor, J., dissenting).

[282] For further discussion of *United States v. General Dynamics*, see Michael Dubetz, United States v. General Dynamics: *The Deducation of Estimated Liabilities by Accrual Method Taxpayers: The All Events Test and Economic Performance*, 49 OHIO ST. L.J. 1439 (1989); and Erik M. Jensen, *The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers*, 22 GA. L. REV. 229 (1988).

[283] 506 U.S. 168 (1993).

None of the hospitals provided him with office space nor did he rent office space. Instead, the taxpayer used a spare bedroom in his condominium exclusively as a home-office, although he did not meet patients there.[284] The Service audited the taxpayer's 1983 income tax return and disallowed claimed expenses for a section 280A qualified home office. The Commissioner determined that the home office was not the taxpayer's principal place of business as required by section 280A(c)(1)(A).[285] A divided Tax Court sustained the deductions and the Fourth Circuit affirmed, adopting the Tax Court's view that "where management or administrative activities are essential to the taxpayer's trade or business and the only available office space is in the taxpayer's home, the 'home office' can be his 'principal place of business.'"[286]

The Supreme Court took the case due to a split in the circuits.[287] It reduced the Fourth Circuit's analysis to a simple test: a qualifying home office may exist "whenever the office is essential to the taxpayer's business, no alternative office space is available, and the taxpayer spends a substantial amount of time there."[288] It then criticized this analysis as supporting a deduction whenever the home office is the "principal office" of the taxpayer, whereas the statute refers to the "'principal place' of business."[289]

The Court then determined that no single objective criterion will resolve the issue for all taxpayers. Rather, it is necessary to consider the "facts of each case" using two primary factors: (1) "the relative importance of the activities performed at each business location and [(2)] the time spent at each place."[290] The Court rejected the Fourth Circuit's view that the "necessity of the functions performed at home" has "much weight in determining entitlement to the deduction."[291]

Epilogue:[292] In the Taxpayers Relief Act of 1997,[293] Congress amended

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[284] *Id.* at 170.

[285] I.R.C. § 280A(c)(1)(A) (1983).

[286] *Soliman*, 506 U.S. at 171 (quoting Soliman v. Commissioner, 935 F.2d 52, 54 (4th Cir. 1991)).

[287] *Id.* at 172.

[288] *Id.* at 174 (citing Soliman v. Commissioner, 935 F.2d 52, 54 (1991)).

[289] *Id.*

[290] *Id.* at 175.

[291] *Id.* at 176.

[292] For further discussion of *Soliman*, see Lauri K. Aldrich, *Rethinking the Home Office Deduction*, 49 TAX LAW. 383 (1996); *see also* John E. Byrnes, Casenote, Commissioner of Internal Revenue v. Soliman*: A Decision Wrongly Decided on*

section 280(c)(1) to permit a taxpayer a home office deduction even if the home office is used only for management or administration-related activities as long the business has no other location for that purpose.[294] In effect, the amendment reversed by statute the Court's holding in *Soliman*.

F. Who is the Taxpayer?

In *Commissioner v. Bollinger*,[295] the taxpayers sought to deduct losses incurred in real estate business ventures.[296] Legal title to the properties was held in the name of a corporation, because the parties were only able to obtain financing for the ventures at interest rates that exceeded the state's usury law applicable to non-corporate borrowers.[297] Agreements between the corporation holding legal title and the individuals memorialized an agency or nominee relationship between the corporation and the individuals.[298] In the litigation, the Service argued that the individual taxpayers were not the owners of the properties that generated the losses. The Tax Court disagreed with the Service, holding that for tax purposes the individuals were the owners of the property and the Sixth Circuit affirmed.[299] The Court granted certiorari to resolve a conflict among the circuits regarding "tax treatment of corporations purporting to be agents of their shareholders."[300]

The issue before the Supreme Court was not one of statutory construction, but rather one of interpreting old precedent.[301] In 1943, on similar facts, the Court in *Moline Properties v. Commissioner*, held that a corporation and its sole shareholder were indeed separate taxpayers and honored the form of the corporation.[302] Six years later,

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"Principal," 2 GEO. MASON INDEP. L. REV. 429 (1994); Malcolm L. Morris, *Suffering* Soliman*'s Solution*, 55 U. PITT. L. REV. 99 (1993).

[293] Pub. L. No. 105-34, 111 Stat. 788.

[294] *Id.* § 932, 111 Stat. at 881.

[295] 485 U.S. 340 (1988).

[296] *Id.* at 342.

[297] *Id.*

[298] *Id.* at 343.

[299] Bollinger v. Commissioner, 48 T.C.M. (CCH) 1443 (1984); Bollinger v. Commissioner, 807 F.2d 65 (1986).

[300] *Bollinger*, 485 U.S. at 341.

[301] *See* Moline Props. v. Commissioner, 319 U.S. 436 (1943) and Nat'l Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

[302] Moline Prop. v. Commissioner, 319 U.S. 436, 439–40 (1943).

National Carbide v. Commissioner set forth a list of factors to determine whether to attribute tax consequences of a corporate agent's actions to a principal.[303] *Bollinger* refined the Court's prior ruling in *National Carbide* by holding that a bona fide agency relationship may exist when the parties have a contemporaneous written agreement, honor the formality of the relationship, and hold the relationship out to third parties as such.[304]

Epilogue:[305] Congress has not modified the Court's holding in *Bollinger*.[306] The test remains fact-specific. Taxpayers may protect themselves from challenges by the Service only by carefully following the Court's guidelines.

G. Amortizing Intangibles Permitted

In *Newark Morning Ledger Co. v. Untied States*,[307] the taxpayer purchased another newspaper corporation and subsequently merged the corporations. Among the assets acquired was an asset described as "paid subscribers," to which it allocated $67.8 million in tax basis separately from the goodwill it purchased in the transaction. On its tax returns, the taxpayer claimed amortization deductions for the asset.[308] In the tax litigation, the Service argued that the "paid subscribers" asset was essentially goodwill and therefore not subject to a depreciation deduction. The trial court ruled for the taxpayer, but the Third Circuit reversed, sustaining the Service's theory.[309] The Court granted certiorari "in order to resolve an issue of substantial importance . . . and to settle a perceived conflict [among the circuits]."[310]

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[303] Nat'l Carbide Corp. v. Commissioner, 336 U.S. 422, 437 (1949).

[304] *Bollinger*, 485 U.S. at 349–50.

[305] For further discussion of *Bollinger*, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.10 at 2-51 (7th ed. 2000); *see also* Bradley N. Liebmann, Note, *Disregarding the Corporate Nominee:* Commissioner v. Bollinger, 42 TAX LAW. 371 (1989).

[306] *See* Mary LaFrance, *The Separate Tax Status of Loan-Out Corporations*, 48 VAND. L. REV. 879 (1995) (discussing *Bollinger*'s importance).

[307] 507 U.S. 546 (1993).

[308] *Id.* at 550.

[309] Newark Morning Ledger Co. v. United States, 945 F.2d 555 (3d Cir. 1991).

[310] *Newark*, 507 U.S. 553, n.5 (comparing the lower court's ruling with Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987); Citizens & Southern Corp. v. Commissioner, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990)).

The Supreme Court held that a taxpayer who can prove the useful life of "customer-based intangibles" may claim depreciation deductions for them notwithstanding their self-generating nature and the assumptions regarding their continuation.[311] To qualify for a depreciation deduction, it is necessary to distinguish goodwill, but that is a question of fact to be decided on a case by case basis.[312] The real issues in dealing with customer-based intangibles, according to the Court, were whether the taxpayer can establish a value and whether that value declines over time.[313] The Court defined "goodwill" succinctly as "the expectancy of continued patronage,"[314] but noted the difficulty of classifying many "customer-based intangibles."[315] Nevertheless, taxpayers may, with sufficient evidence, be able to establish the value and useful life of those assets separate and apart from goodwill.[316] Four Justices argued in dissent that the taxpayer could not distinguish its paid subscribers list from goodwill.[317]

Epilogue:[318] Section 197, enacted in 1993 (the same year that the Court decided *Newark Morning Ledger*), provides for a fifteen-year amortization period for goodwill and other intangibles, including certain types of customer-based intangibles.[319]

VIII. CORPORATE TAXATION CASES

A. Target Acquisition Expenses are Capital

In *INDOPCO, Inc. v. Commissioner*,[320] the taxpayer, a publicly held corporation, was acquired in a friendly, tax-free acquisition. As a part of evaluating the acquisition proposal, the taxpayer incurred

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311 *Id.* at 558, 566.

312 *Id.* at 556.

313 *Id.* at 560.

314 *Id.* at 555.

315 *Id.* at 566.

316 *Id.* at 570.

317 *Id.* at 571 (Souter, J., dissenting).

318 For further discussion of *Newark Morning Ledger*, see Michael J. Douglass, *Tangible Results for Intangible Assets: An Analysis of New Code Section 197*, 47 TAX LAW. 713 (1994) (discussing the Court's decision in *Newark Morning Ledger* and the impact of section 197) and George L. Middleton & Christian M. McBurney, *The Morning After* Newark Morning Ledger*: What Should Taxpayers Do Now?*, 59 TAX NOTES 817 (May 10, 1993).

319 I.R.C. § 197.

320 503 U.S. 79 (1992).

substantial investment banking and legal fees, which it sought to deduct as ordinary and necessary business expenses under section 162. On audit, the Service contended the expenses were capital in nature and not currently deductible.[321] The Court granted certiorari based on a perceived conflict among the circuits.[322]

On appeal to the Supreme Court, the taxpayer relied on a 1971 opinion of the Court, *Commissioner v. Lincoln Savings & Loan Ass'n.*[323] In that decision, the Court held expenses that create "a separate and distinct additional asset" for the taxpayer are capital in nature.[324] In *INDOPCO*, the taxpayer asserted that *Lincoln Savings* stood for the proposition that an expenditure must create a separate and distinct additional asset to be capital.[325] The Court quickly rejected this interpretation of its prior decision, and then analyzed INDOPCO's acquisitions expenses under the requirements of section 162, determining they were not "ordinary and necessary" business expenses.[326] The Court also noted that established precedent held that expenses incurred to change a corporation's structure are not deductible under section 162, and held that because the expenses in question were incurred precisely to change the corporation's structure, no deduction under that section was available.[327]

Epilogue:[328] The Court's ruling that INDOPCO's expenses had some future benefit to the corporation, and thus were capitalized, has not been altered by Congress. Nevertheless, the capitalization of reorganization expenses was not settled until the Treasury Department issued a regulation.[329] Most notably, the Treasury Regulation replaced *INDOPCO*'s presumption that such expenses create capital with a presumption that such expenses are deductible as

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[321] *Id.* at 82.

[322] *Id.* at 83.

[323] *Lincoln Sav. & Loan Ass'n*, 403 U.S. at 354.

[324] 503 U.S. at 86.

[325] *INDOPCO*, 503 U.S. at 86.

[326] *Id.* at 88.

[327] *Id.* at 89–90.

[328] For further discussion of *INDOPCO*, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 5.04[4], 5.06[2][a], 5.06[2][d] (7th ed. 2000); *see also* Glenn R. Carrington, *Capitalization After* INDOPCO *and Into the New Millennium*, 93 TAX NOTES 813 (Nov. 5, 2001); Peter L. Faber, INDOPCO*: The Still Unsolved Riddle*, 47 TAX LAW. 607 (1994).

[329] Treas. Reg. § 1.263(a)-(4), -(5) (2004).

current expenditures unless they are of a type included on a list of "capital expenses" included in the regulation.[330]

B. Discharge of Indebtedness Income for S Corporations

In *Gitlitz v. Commissioner*,[331] the taxpayers were shareholders of an S corporation. For the tax year in question, the S corporation realized discharge of indebtedness income, but that amount was not gross income for the corporation, because discharge of indebtedness income is not gross income if and to the extent the taxpayer is insolvent.[332] Notwithstanding the corporate exclusion from gross income, the shareholders of the S corporation increased their income tax basis in their stock by the amount of the discharge of indebtedness income. They relied on section 1366(a)(1)(A), which increases a shareholder's basis by items of corporate income, asserting that the statute does not require an item of income to be an item of gross income to trigger a basis adjustment.[333] With the increased basis in their S corporation stock, the taxpayers were able to deduct losses that passed through from the S corporation.[334]

The Commissioner rejected the taxpayers' view of the law and countered that an exclusion from gross income means that the discharged income is not an "item of income" to pass through and increase shareholders' basis under section 1366.[335] The Commissioner's argument did not sway the Court, however, which held that the plain meaning of the statutes involved supported the taxpayers' interpretation.[336] The Court pointed out that other "items of income," such as tax-exempt income, are excluded from gross income yet provide a positive basis adjustment for S corporation shareholders.[337]

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330 For a discussion of the new Treasury Regulation, see Richard L. Alltizer & Jeffery J. Bryant, *An Analysis of the Final Code Sec. 263(a) Regulations on Capitalization of Intangible Assets*, TAXES, July 2004, at 39; *see also* Gary L. Maydew, *New Code Section 263 Capitalization Regulations Provide Guidance,* TAXES, August 2004, at 50; Matthew A. Melone, *Final Intangible Asset Regulations Modify and Clarify, but Conform in Most Respects, to the Proposed Rules*, 31 CORP. TAX'N 15 (2004).

331 531 U.S. 206 (2001).

332 I.R.C. § 108(a)(1)(B), (d)(7)(A)(2000).

333 *Gitlitz*, 531 U.S. at 210.

334 *Id.*

335 *Id.* at 212.

336 *Id.*

337 *Id.* at 212–14.

Having determined that discharge of indebtedness income that is exempt from taxation under section 108 may provide a basis adjustment, the Court addressed a second issue. Section 108(b) provides that the tax attributes of the S corporation are reduced by the amount of the discharge of indebtedness income excluded from gross income under section 108(a).[338] The question presented was whether to reduce the tax attributes before or after the basis-adjusting "item of income" passes through to the shareholders. The Tenth Circuit had agreed with the Commissioner that the reduction occurs before the pass-through.[339]

The Court quoted the applicable statute, section 108(b)(4)(A), which "directs that the attributable reductions 'shall be made *after* the determination of the *tax imposed* by this chapter for the taxable year of the discharge.'"[340] The Court's analysis suggested that the plain meaning of the statute requires S corporation shareholders to adjust basis to determine their tax liability.[341] The Court rejected the Tenth Circuit's reasoning that allowing an upward adjustment of basis would somehow prevent the reduction in tax attributes. Instead it determined that the statute permits both.[342] The Court also rejected a policy argument that taxpayers received the double benefit of an exclusion from income and an upward adjustment to basis, because the "Code's plain text" provides for that result.[343] Justice Breyer, in his solo dissent, disagreed with the majority that the statute had such a clear meaning. He concluded that the statute was ambiguous and thus could be interpreted as the Commissioner asserted to deny the alleged double benefit.[344]

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[338] The primary tax attribute in question in *Gitlitz* was the net operating loss deduction. If the discharge of indebtedness income was first offset by the net operating loss of the S corporation, no item of income would remain to pass through to the shareholders. *Gitlitz*, 531 U.S. at 216–17 (citing I.R.C. §§ 108(b)(1), (2), 108(d)(7)(B)).

[339] The Sixth Circuit in *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000), and the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), agreed with the Tenth Circuit, but the Third Circuit in *United States v. Farley*, 202 F.3d 198 (2000), agreed with the taxpayer, creating a circuit split.

[340] *Gitlitz*, 531 U.S. at 218 (emphasis in original).

[341] *Id.*

[342] *Id.* at 218–19.

[343] *Id.* at 220.

[344] *Id.* at 220 (Breyer, J. dissenting).

Epilogue:[345] Congress did not allow the *Gitlitz* result to stand very long. In the Jobs Creation and Workers Assistance Act of 2002, Congress amended section 108(d)(7)(A) to provide that income items for an S corporation that are excluded under section 108 are not income items taken into account for the shareholders and there is no adjustment to basis for the S stock.[346] This change took effect on October 11, 2001, just nine months after the Court decided *Gitlitz*. In effect, the legislation also validated Treasury Regulation section 1.1366-1(a)(2)(viii), which was likely invalidated by *Gitlitz*, although that regulation was not mentioned in any of the Court's opinions.

C. Reorganization Boot is Capital Gain

Commissioner v. Clark[347] involved the tax treatment of the sole shareholder of a corporation who disposed of his stock in a triangular reorganization.[348] The issue was not the qualified status of the reorganization,[349] but rather the characterization of the cash "boot"[350] received by the taxpayer in the exchange. The taxpayer reported the cash received as capital gain income, but on audit, the Service asserted the money was a dividend taxable at regular income tax rates.[351] Competing theories supported each side of the controversy: if the cash received was deemed to have been paid to the taxpayer just before the exchange of stock in the reorganization, the money was clearly a dividend; if deemed paid immediately following the reorganization, the money was subject to more favorable capital gain taxes.[352]

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[345] For a further discussion of *Gitlitz*, see Julie F. Bell, *Assessing S Corporation Cancellation of Debt Income on Shareholders' Income and Basis in the S Corporation's Stock:* Gitlitz v. Commissioner, 54 TAX LAW. 671 (2001); *see also* Richard M. Lipton, *Supreme Court Hands Taxpayers a Victory in* Gitlitz, *but Will Congress Take it Away?*, 94 J. TAX'N 133 (2001).

[346] Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 402, 116 Stat 21, 40.

[347] 489 U.S. 726 (1989).

[348] A triangular reorganization involves the transfer of the stock of the target corporation to a controlled subsidiary of the acquiring corporation in exchange for stock in the acquiring corporation. Sometimes, as in the situation here, the shareholders of the target corporation will receive cash, or "boot," in addition to stock in the acquirer.

[349] *Id.* at 732.

[350] *Clark*, 489 U.S. at 732. "Boot" is the common name for property that is taxable, but received in a transaction that is in part tax free.

[351] *Id.*

[352] *Id.* at 732–33.

The Tax Court adopted the taxpayer's view.[353] It did not believe that the cash received should be isolated from the reorganization, as though the reorganization never happened. It conceded that the cash payment really did not occur until after the reorganization, but pointed out that it did occur because of and only because of the reorganization.[354] On appeal, the Fourth Circuit agreed with the taxpayer in *Clark*.[355] However, the Fifth Circuit, in *Shimberg v. United States*,[356] had previously held that cash boot is deemed a pre-reorganization payment or is calculated as though the reorganization did not occur. Because of the conflict between the circuit courts, the Court granted certiorari.[357]

Twice previously, but many years earlier, the Supreme Court had considered whether cash received in exchange for stock of a single corporation was taxable as a dividend.[358] In those decisions, the Court "agreed with the Government largely because the transactions involved redemptions of stock by single corporations that did not 'result in a meaningful reduction of the shareholder's proportionate interest in the corporation.'"[359]

Clark was the third case in which the Government asked the Court to decide that a shareholder's receipt of a cash payment in exchange for a portion of his stock was taxable as a dividend. The different facts of *Clark* lead to a different result from the previous two. In *Clark*, more than one corporation was involved in the reorganization and the taxpayer did not retain the majority voting interest he owned before the reorganization – he went from one hundred percent ownership of the target corporation to owning less than one percent of the acquirer.[360] The Court concluded that the transaction had no appearance of a dividend but rather looked like a sale of stock that is usually taxed as a capital gain.[361]

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[353] Clark v. Commissioner, 86 T.C. 138 (1986).

[354] *Id.* at 150–53, 155.

[355] Clark v. Commissioner, 828 F.2d 221 (4th Cir. 1987).

[356] 577 F.2d 283 (5th Cir. 1978).

[357] *Clark*, 489 U.S. at 737.

[358] United States v. Davis, 397 U.S. 301 (1970) (involving the redemption of preferred stock by one shareholder who was deemed to own all of the remaining outstanding stock of the corporation as a result of attribution rules); Commissioner v. Bedford's Estate, 325 U.S. 283 (1945) (involving the reorganization of a single corporation).

[359] *Clark*, 489 U.S. at 728 (quoting *Davis*, 397 U.S. at 313).

[360] *Id.* at 731–32.

[361] *Id.* at 744–45.

Epilogue:[362] The Service, in Revenue Ruling 93-62,[363] announced that in reorganization matters it would apply the principles of section 302 concerning when redemptions will be treated as exchanges and taxed as capital gains. Thus, the Revenue Ruling affirmatively adopted the Court's ruling in *Clark*. This concession by the government is favorable for individual taxpayers. However, it is not necessarily good news for corporate taxpayers, as the dividend-received exclusion of section 243 is likely to produce a lower tax than capital gains. In the context of section 306 preferred stock issued in the acquisition, the tax effect of *Clark* is more complex, but a consideration of those issues is beyond the scope of this article.

D. Consolidated Return Loss Carryback

In *United Dominion Indus., Inc. v. United States*,[364] the Court granted certiorari because of a conflict among the Circuits.[365] This case involved a complicated tax controversy including loss carrybacks for affiliated corporations filing consolidated returns. It was the first time the Court had reviewed a consolidated return issue in sixty-seven years.[366] The Service proposed requiring each unit of the consolidated group to compute the loss on a separate basis, while the taxpayer proposed that an affiliated group should be deemed a single entity for the computation. The Court, in an opinion that mostly interpreted Treasury Department Regulations,[367] sided with the taxpayer and determined that a single-entity method for calculating net operating losses was correct.[368] This interpretation permitted a ten-year carryback of the losses when the consolidated group as a whole had a consolidated net operating loss deduction. The Court noted that the Government's own regulations decided the issue and invited the

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[362] For further discussion of *Clark*, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 12.44[2][c], 12.45[3] (7th ed. 2000).

[363] 1993-2 C.B. 118.

[364] 532 U.S. 822 (2001).

[365] *Id.* at 828–29.

[366] In 1934, the Court decided three cases involving consolidated returns: *McLaughlin v. Pacific Lumber Co.*, 293 U.S. 351 (1934); *Helvering v. Morgan's Inc.*, 293 U.S. 121 (1934); and *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934).

[367] In particular, the Court interpreted Treas. Reg. sections 1.1502-12, -21, and -79 as they existed between 1983 and 1986. *United Dominion*, 532 U.S. at 826 n.3.

[368] *United Dominion*, 532 U.S. at 824.

government to change the regulations if it wanted a different result.[369]

Justice Stevens's dissent concluded that the regulations did not answer the question, and thus, argued that concerns about abuse should tilt the resolution in favor of the government.[370] Justice Thomas, in his concurring opinion, responded to the dissent by arguing that the tilt should favor the taxpayer when the interpretation of the regulations is in doubt.[371]

Epilogue:[372] It appears that the Service did not use *United Dominion* as a catalyst to modify the regulations and reverse the Court's result. However, the Service has since used the rule of *United Dominion* to support a change in the consolidated return regulations to require the reduction of tax attributes of the entire group when applying the discharge of indebtedness rules of section 108.[373]

E. Stock Surrender is Not a Loss Recognition Event

In *Commissioner v. Fink*,[374] the taxpayers were controlling shareholders of a corporation. In an attempt to make the corporation more attractive to outside investors, the taxpayers surrendered stock in the corporation, although they retained majority control of the corporation. On their joint tax return, the taxpayers claimed loss deductions for the stock surrendered.[375] The Court granted certiorari because of a conflict among the circuits.[376]

The Court analogized the surrender of stock to a contribution to capital even though a surrender has no effect on the balance sheet of the corporation. The taxpayers surrendered the stock to protect their investment in the corporation. In that context, the Court concluded that it is not possible to determine the amount of the loss sustained as required by section 165.[377] Moreover, permitting a loss deduction on

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369 *Id.* at 837–38.

370 *Id.* at 842 (Stevens, J., dissenting).

371 *Id.* at 838–39 (Thomas, J., dissenting).

372 For further discussions of *United Dominion*, see Jared H. Gordon, *Unbaking the Consolidated Cake: Deciphering the Impact of* United Dominion, 28 J. CORP. TAX'N 3 (2001), and Christina I. Smith, Note, *Challenging the Treasury:* United Dominion Industries, Inc. v. United States, 17 AKRON TAX J. 61 (2002).

373 *See* T.D. 9192, Treas. Dec. Int. Rev. 9192.

374 483 U.S. 89 (1987).

375 *Id.* at 91.

376 *Id.* at 94.

377 *Id.* at 97.

these facts might lead to the conversion of future capital losses into currently deductible ordinary losses.[378] The Court ruled that the appropriate tax treatment was to increase the basis of shares retained rather than to allow any current loss deduction.[379] The relinquishment of stock was not deemed the appropriate event to recognize a loss within the terms of section 1001.[380]

Epilogue:[381] Congress has not enacted legislation to reverse the result in *Fink*.

IX. ESTATE AND GIFT TAX CASES

As evidenced by the discussions above of damages cases and charitable cases,[382] when a relatively long-term view is taken of the Supreme Court's tax jurisprudence, one pattern that appears is the Court's willingness to venture into an area and then fine tune or provide additional guidance when related issues arise. This pattern appeared for a third time with disclaimers.

A. Pre-1977 Disclaimer Considered

The Court first ventured into the gift tax aspects of disclaimers in *Jewett v. Commissioner*,[383] a decision made by the Burger Court,[384] four years before Justice Rehnquist became the Chief Justice. In *Jewett*, the Court ruled that a disclaimer of an interest in a trust thirty-three years after the interest was created in 1939 was a taxable gift, although the interest was still contingent at the time the disclaimer

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[378] *Id.* at 98.

[379] *Id.* at 99–100.

[380] *Id.* at 100.

[381] For further discussion of *Fink*, see Gwendolyn Griffith, *Realization and Recognition of Losses on Stock Surrenders: A Frolic Through Subchapter C*, 17 FLA. ST. U. L. REV. 49 (1989), in which the author explores in detail the policy underlying the *Fink* decision and its impact on taxpayers. The author agreed with the Court's result because no capital left the entity, a prerequisite for a realization event in that context. *See also* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.13[4][a] (7th ed. 2000); Jerald D. August & Steven J. Levine, *Sup. Ct. in* Fink *Holds Non-Pro Rata Stock Surrenders Are Capital Contributions*, 67 J. TAX'N 130 (1987).

[382] *See supra* Parts V and VI.

[383] 455 U.S. 305 (1982).

[384] Justice Stevens wrote the opinion for the majority, and Justice Blackmun, joined by Justices Rehnquist and O'Connor, dissented.

was signed. The applicable rule for the tax effect of the disclaimer was contained in a Treasury Regulation, which provided that a disclaimer effective under local law must be made "within a reasonable time after knowledge of the existence of the transfer."[385] The Court granted certiorari in *Jewett* to resolve the conflict among the circuits.[386] In *Jewett*, the Ninth Circuit ruled for the government, but earlier the Eighth Circuit had ruled for the taxpayer when addressing the same issue in *Keinath v. Commissioner*.[387]

The *Jewett* Court began with a statutory analysis and concluded that the gift tax is sufficiently broad to tax a contingent interest in property, citing *Smith v. Shaughnessy*.[388] Moreover, the Court found that the policy of the gift tax — supplementing the estate tax — is served by taxing disclaimers, because disclaimers have the effect of reducing the size of the disclaimant's potential estate tax liability.[389] Notwithstanding the statutory meaning and the policy of the gift tax, however, the Court found that the regulation permitted certain disclaimers to take effect without incurring a gift tax if the disclaimer (1) was effective under state law, and (2) was made within a reasonable time of learning of the interest in property.[390]

Thus, the Court set the stage to decide when an interest in property is transferred to the taxpayer. The Court answered that it occurred when the contingent interest was created, not at final vesting of that interest.[391] Having reached that decision, the Court easily concluded that the taxpayer had waited too long.[392]

Epilogue:[393] The Court's decision in *Jewett*, like the *Irvine* decision discussed below, addressed disclaimers under pre-1977 disclaimer regulations. The precedent of both cases is very limited because

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[385] Treas. Reg. § 25.2511-1(c)(1) (1981).

[386] *Jewett*, 455 U.S. at 308–09.

[387] *See* Jewett v. Commissioner, 638 F.2d 93, 95 (9th Cir. 1981); Keinath v. Commissioner, 480 F.2d 57, 57 (8th Cir. 1973).

[388] *Jewett*, 455 U.S. at 309–10 (citing Smith v. Shaughnessy, 318 U.S. 176 (1943)).

[389] The *Jewett* Court favorably cited *Sanford's Estate v. Commissioner*, 308 U.S. 39 (1939). *Jewett*, 455 U.S. at 310.

[390] *Jewett*, 455 U.S. at 310–11.

[391] *Id.* at 318.

[392] The taxpayer argued that the time to disclaim did not start until he reached the age of majority, but that was still twenty-four years before the disclaimers and too long of a delay in the Court's opinion. *Id.* at 318–19.

[393] For further discussion of *Jewett*, see Don J. Jaret, *I.R.C. Section 2518 and the Law of Disclaimers — An Update*, 7 NOVA L.J. 243 (1983).

section 2518, enacted in 1976, provides statutory rules for qualified disclaimers.[394]

B. Pre-1977 Disclaimer Reconsidered

Twelve years after *Jewett*, the Rehnquist Court granted certiorari in its first disclaimer controversy, *United States v. Irvine*.[395] In 1979, Irvine executed a valid state[396] law disclaimer of a 1917 trust interest. The trust interest was created before Congress enacted the current gift tax in 1932.[397] In *Irvine*, the Service assessed a gift tax asserting that the disclaimer was a taxable gift of property and subject to the gift tax.

The Court accepted the case because of a conflict in the circuits.[398] The Court framed the issue as "whether a disclaimer made after the enactment of the gift tax statute, of an interest created before enactment, is necessarily free of any consequent federal gift taxation."[399] This was factually different than *Jewett*, since the trust interest disclaimed in *Jewett* was created after the 1932 enactment of the gift tax, but the trusts in *Irvine* and *Ordway* were established before 1932. The Court's analysis began with Treasury Regulation section 25.2511 because the disclaimed property interest arose before the 1976 enactment of section 2518 and its statutory rules for qualified disclaimers.[400] The Court assumed that the regulation was valid, and therefore that if it applied to the disclaimer in dispute the disclaimer would result in assessment of tax.[401] The regulation provided that a disclaimer must be made within a "reasonable time" after the disclaimant learns of the property interest received to avoid gift tax liability and the Court in *Jewett* had sustained this rule.[402]

The regulation was only a portion of the Court's analysis to

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[394] Under section 2518, disclaimers made after 1976 must be made within nine months of the transfer creating the property interest. I.R.C. § 2518(b)(2). There is a minor exception to the nine-month rule for underage donees. *See* § 2518(b)(2)(B); Treas. Reg. § 25.2518-2(c) (1997). Section 2518 was inapplicable in *Jewett* because the taxpayer executed his disclaimer in 1972, four years before the section's passage.

[395] 511 U.S. 224 (1994).

[396] Minnesota was the applicable state law.

[397] *See* Revenue Act of 1932, ch. 209, §§ 501–32, 44 Stat. 169, 245–59.

[398] *Irvine*, 511 U.S. at 227.

[399] *Id.*

[400] *See supra* note 394 and accompanying text.

[401] *Irvine*, 511 U.S. at 234.

[402] *See supra* note 390and accompanying text.

determine if the gift tax applied to a disclaimer of a property interest that arose before the enactment of the gift tax. The Court also reviewed the policy for the enactment of the gift tax, which was "to prevent or compensate for avoidance of death taxes by taxing the gifts of property."[403] This policy, the Court thought, reinforced the regulation's "reasonable time" rule. To permit Mrs. Irvine forty-seven years to disclaim her interest permitted her "a virtually unlimited opportunity to consider estate planning consequences."[404]

Next, the Court rejected an attack based on the state law effectiveness of the disclaimer. Even though, as the Court noted, states permit disclaimers to bar "the disclaimant's creditors [in this case the United States Government] . . . from reaching the disclaimed property[,]"the goal of state law of allowing disclaimers to defeat creditors' claims differed from the goals of the federal gift tax of supplementing the estate tax and preventing estate tax avoidance, and the Court thought that, in this case at least, state law policies regulating creditors' interests should not be permitted to defeat federal tax regulations.[405] In so holding, the Court noted that federal tax policy is not served by incorporating "state-law fictions as touchstones of taxability."[406] Only by the grace of the regulation's parameters is the taxpayer's disclaimer permitted to defeat the gift tax.

Finally, the Court concluded that taxing the disclaimer as a gift did not violate the gift tax enactment transitional rule that transfers occurring before enactment are not taxed.[407] A taxpayer may not escape the gift tax because the property interest existed before the gift tax was enacted. Thus, although the taxpayer's disclaimed property interest was created before enactment, the disclaimer and gift taxing occurred after enactment. The state-law legal fiction that disclaimers relate back to the time of the original transfer, the Court held, is not part of federal tax law and does not preclude federal gift taxation of those disclaimers.[408]

[403] *Irvine*, 511 U.S. at 235 (quoting Sanford's Estate v. Commissioner, 308 U.S. 39, 44 (1939)).

[404] *Id.*

[405] *Id.* at 240.

[406] *Id.*

[407] *Id.* at 241.

[408] *Id.*

Epilogue:[409] The Court's decision in *Irvine*, like *Jewett* discussed above, addressed disclaimers under pre-1977 disclaimer regulations. The precedential value of both cases is very limited. Nevertheless, the Court used its reasoning in *Jewett* and *Irvine* in its *Drye* decision discussed below.

C. Disclaimer Does Not Defeat Tax Lien

The next disclaimer case the Court considered was *Drye v. United States*.[410] In a unanimous opinion, the Court ruled that a disclaimer valid under state law does not defeat a federal tax lien.[411] Unlike *Jewett* and *Irvine*, *Drye* is not a gift tax case. Thus, section 2518 is not controlling and was barely mentioned by the Court,[412] even though it appears that the taxpayer's disclaimer was likely within the statutory rules of section 2518. Rather, *Drye* is a case in which the United States, as a creditor, sought to levy on a delinquent taxpayer's property. In *Drye*, the decedent's son was insolvent and owed taxes. After the decedent's death, the son disclaimed his interest in his mother's intestate estate. The disclaimer was valid under Arkansas state law. As a result, the decedent's estate then passed to the son's daughter (the decedent's granddaughter) who then funded a spendthrift trust (valid under state law) for her benefit and for the benefit of her parents (the decedent's son and his wife). The Service sought to enforce its lien against the trust by levy on the assets.[413] The Supreme Court granted certiorari to resolve the conflict among the circuits.[414]

The Court started with a review of applicable statutes: the lien statute is section 6321, the levy statute is section 6331, and there is a list of exclusions in section 6334. Inheritances are not specifically included in the list of exceptions from levy.[415] Nevertheless, the taxpayer asserted that the state law is determinative of whether the decedent's son had a property interest in his mother's estate.[416] The

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[409] For further discussion of *Irvine*, see E. Bruce Jorgensen, Note, *Disclaimers of Interests Created Before Enactment of the Gift Tax:* United States v. Irvine, 48 TAX LAW. 553 (1995).

[410] 528 U.S. 49 (1999).

[411] *Id.* at 52.

[412] *Id.* at 57; I.R.C. § 2518 (1996).

[413] *Drye*, 528 U.S. at 53.

[414] *Id.* at 55.

[415] *Id.* at 55–57.

[416] *Id.* at 57.

Court turned to its prior decision in *Irvine* to conclude that state law does not determine what an interest in property is for federal tax purposes. Rather, it ruled that even with a disclaimer of an inheritance, a taxpayer "inevitably exercises dominion over the property."[417] This right of control was a property interest within the meaning of section 6321, the lien statute.[418]

Without saying it in so many words, the Court views disclaimers as creatures of state law that exist primarily to regulate state law debtors and creditors. Disclaimers and their "relation-back" doctrine are meaningless for federal tax law purposes. It is only when Congress by section 2518, or the Treasury Department by now obsolete Regulation 25.2511, decided that a disclaimer may avoid the imposition of a gift tax does a disclaimer have any federal tax meaning and then only to the extent specifically permitted.

Epilogue:[419] There has been no legislative or regulatory response to *Drye.*

D. Estate Expenses and the Marital Deduction

The only other substantive estate or gift tax case considered by the Rehnquist Court was *Commissioner v. Hubert.*[420] In *Hubert*, the Court reviewed whether the estate tax marital and charitable deductions are reduced when the estate uses fiduciary accounting income to pay estate administration expenses. The Court granted certiorari because of a conflict among the ciruits.[421]

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[417] *Id.* at 61.

[418] *Drye*, 528 U.S. at 61.

[419] For further discussion of *Drye*, see Steve R. Johnson, *The Good, the Bad, and the Ugly in Post-Drye Tax Lien Analysis*, 5 FLA. TAX REV. 415 (2002); Claudia M. Osorio, *Disclaimer of Intestate's Estate Under Arkansas Law Cannot Prevent Attachment of Federal Tax Lien:* Drye v. United States, 53 TAX LAW. 951 (2000); Edward Kessel, Steven R. Klammer, *Supreme Court Finds Disclaimer Ineffective to Avoid Federal Tax Lien*, 92 J. TAX'N 118 (2000).

[420] 520 U.S. 93 (1997). Besides the disclaimer cases considered in this section, two of the constitutional cases, *Wells Fargo*, *supra* notes 17–30 and accompanying text, and *Carlton*, *supra* notes 45–58 and accompanying text, involved estate and gift taxes. Also, in *United States v. Dalm*, 494 U.S. 596 (1990), the Court considered a gift tax statute of limitations question. Justice Kennedy, for the majority, reversed the circuit court ruling that the doctrine of equitable recoupment did not open the gift tax statute of limitations. The taxpayer asserted that the same transfer had been income taxed. Two other Justices joined Justice Stevens in dissent.

[421] *Id.* at 99.

The Hubert estate incurred substantial administrative expenses, nearly $2 million. For fiduciary accounting purposes, the estate paid a portion of the expenses from estate income and a portion from estate principal.[422] Thereafter, when computing the amount of the estate tax charitable and marital deductions, the estate did not include in the deductions any amount of estate principal used to pay the expenses, but it did not reduce the value of the deductions by the amount of estate administration expenses paid from estate income.[423] The Service disagreed, asserting that the deductions were reduced by estate administration expenses even when paid from fiduciary accounting income.[424] The Tax Court agreed with the taxpayer and the Eleventh Circuit affirmed.[425]

The Court began its analysis with the controlling statute, section 2056, but quickly concluded that it did not resolve the issue. The opinion of the plurality next examined in detail the relevant Treasury Regulations and ruled that "[t]he Commissioner's position is inconsistent with the controlling regulations."[426] Three Justices concurred in result.[427] They found neither the Code nor its legislative history helpful in resolving the question. Unlike the majority, they found no guidance in the regulations. In concluding their concurring opinion, these Justices invited the Treasury Department to issue regulatory guidance.[428]

Epilogue:[429] Subsequent to the Court's opinion in *Hubert*, the

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[422] Statutory rules for fiduciary accounting are contained in all three versions of the Uniform Principal and Income Acts promulgated by the National Conference of Commissions on Uniform State Laws. *See* UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. (1931, 1962, 1997). Most states have adopted one of the three Uniform Acts. A discussion of fiduciary accounting is beyond the scope of this article.

[423] *Hubert*, 520 U.S. at 98–99.

[424] *Id.* at 99.

[425] Commissioner v. Estate of Hubert, 101 T.C. 314 (1993), *aff'd*, 63 F.3d 1083 (11th Cir. 1995).

[426] *Hubert*, 520 U.S. at 111. Justice Kennedy wrote the plurality opinion, joined by Chief Justice Rehnquist and Justices Stevens and Ginsburg.

[427] *Id.* at 111 (O'Connor, J., concurring). Justices Souter and Thomas joined Justice O'Connor.

[428] *Id.* at 122 (O'Connor, J., concurring).

[429] For further discussion of *Hubert*, see Joseph M. Dodge, *Lifting the Shroud Obscuring* Estate of Hubert*: The Logic of the Income and Estate Tax Treatment of Estate Administration Expenses*, 3 FLA. TAX REV. 647 (1998); John M. Purcell, Note, *Estate Tax Marital and Charitable Deductions Did Not Have to Be Reduced by Post-Mortem Income Used to Pay Administration Expenses:* Commissioner v. Estate of

Treasury Department accepted the Court's suggestion to alter the result in *Hubert*. Final regulations issued in 1999 provide detailed rules for the tax treatment of estate administration expenses that are charged against marital or charitable shares.[430]

X. CONCLUSION

It is quite surprising the number of times the Supreme Court considered a substantive tax issue that had already been resolved by legislation before the Court's opinion or was subsequently resolved by legislation or administrative action by the Service. This article observes that this happened more than fifty percent of the time.

The frequent reaction by Congress and Treasury Department to issues the Court deems significant brings to mind the statement of Justice Douglas who said:

> I protest now what I have repeatedly protested, and that is the use of this Court to iron out ambiguities in the Regulations or in the [Code], when the responsible remedy is either a recasting of the Regulations by Treasury or presentation of the problem to the Joint Committee on Internal Revenue Taxation which is a standing committee of the Congress that regularly rewrites the [Code] and is much abler than we are to forecast revenue needs and spot

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Hubert, 51 TAX LAW. 451 (1998).

[430] Treas. Reg. §§ 20.2055-3(b)(1)(I), 20.2056(b)-4(d)(1)(I) (1999). The regulations make a distinction between "estate transmission expenses" and "estate management expenses." Estate management expenses are those expenses that could have been incurred by the decedent during life or by the beneficiaries, had they received the property on the date of death without any intervening period of administration. This includes, for example, costs of maintaining and preserving estate assets during the estate administration, investment advisory fees, stock brokerage commissions, custodial fees, and interest. *Id.* Such expenses may be paid from the income of a marital or charitable share and deducted for income tax purposes without a corresponding reduction in the estate tax marital or charitable deduction. The final regulations clarify that such estate management expenses deducted on the estate tax return as administration expenses, rather than on the fiduciary income tax return, reduce the marital or charitable deduction. Treas. Reg. § 20.2055-3(b)(3), 20.2056(b)-4(d)(3), 20.2056(b)-4(d)(5)(Example 4) (1999). Estate management expenses paid from a marital or charitable share also reduce the estate tax marital or charitable deduction, if the expense is attributable to another share of the estate. Treas. Reg. §§ 20.2055-3(b)(4), 20.2056(b)-4(d)(4), 20.2056(b)-4(d)(5)(Example 3) (1999).

loopholes where abuses thrive.[431]

The wisdom of Justice Douglas' opinion should not be lost. The Court is able to review only a limited number of controversies each year. To have Congress or the Treasury Department "gut" the Court's effort to resolve a tax controversy means that some other important issue was not considered by the Court. The present method of resolving tax controversies is not maximizing the value of limited resources. Of course, practical problems will arise if the Court does not resolve disagreements among the circuits because Congress does not always act to resolve the disputes with legislation. Moreover, you must wonder if the Supreme Court accepting a tax case energizes Congress. If this is reality, then the Court is significantly contributing to the resolution of tax controversies, if for no other reason than its acceptance of a case signifies that Congress has not resolved an issue even when the disagreement is widespread. One possible solution that commentators have suggested is a national tax of court of appeals. Unfortunately, a detailed discussion of an appellate tax court is beyond the scope of this article, but maybe it is time to renew those discussions.[432]

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[431] United States v. Generes, 405 U.S. 93, 114–15 (1972) (Douglas, J., dissenting).

[432] One possible solution advocated by other commentators is a national tax court of appeals. *See, e.g.*, Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT'L L. 79 (1998); Samuel B. Sterrett, *Federal Tax Practice for Young Lawyers*, FED. B.A. SEC. TAX'N REP. 5 (1995); Margaret L. Thum, Note, *Confusion in the Courts: The Failure to Tax Punitive Damages Uniformly in Personal Injury Cases*, 23 HASTINGS CONST. L.Q. 591 (1996); Paul E. Treusch, *What to Consider in Choosing a Forum to Resolve an Ordinary Tax Dispute*, 55 TAX LAW. 83 (2001).