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Jeff Kirk

TAXATION

I. SELECTIVE PROSECUTION OF TAX PROTESTORS: DID THE NINTH CIRCUIT GO TOO FAR?

A. INTRODUCTION

In *United States v. Wilson*,[1] the Ninth Circuit held that selective prosecution[2] claims are immediately appealable, and, that absent a showing that others who were similarly situated but who had not exercised their constitutional rights were not prosecuted, a defendant is not entitled to dismissal of the indictment on grounds of selective prosecution.[3]

The Wilsons were indicted for deliberately falsifying federal income tax withholding statements.[4] Defendants moved to quash the indictment on the grounds of selective prosecution, alleging that they were singled out because they protested against the tax laws.[5] Defendants attached a lengthy memorandum to their tax returns setting forth their belief in the unconstitutionality of the tax law and refused to answer any questions on fifth amendment grounds.[6]

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1. 639 F.2d 500 (9th Cir. 1981) (per Goodwin, J.; the other panel members were Kilkenny, J., and Real, D.J., sitting by designation, concurring).

2. Selective prosecution exists when a defendant is prosecuted under an unjustifiable standard such as race, religion or other arbitrary classification. Oyler v. Boles, 368 U.S. 448, 456 (1962). This standard was initially expanded to prohibit prosecution based on the exercise of first amendment rights. United States v. Choate, 619 F.2d 21, 23 (9th Cir.), *cert. denied*, 449 U.S. 951 (1980); United States v. Scott, 521 F.2d 1188, 1195 (9th Cir.), *cert. denied*, 424 U.S. 955 (1975); United States v. Steele, 461 F.2d 1148, 1151 (9th Cir. 1972). Later, the standard was expanded to include the exercise of constitutional rights. United States v. Wilson, 639 F.2d at 504; United States v. Berrios, 501 F.2d 1207, 1211 (2d Cir. 1974).

3. United States v. Wilson, 639 F.2d at 504.

4. *Id.* at 501. The Wilsons were indicted under 26 U.S.C. § 7205 (1976) which provides, in part, that "[a]ny individual required to supply information to his employer . . . who willfully supplies false or fraudulent information . . . shall . . . upon conviction thereof, be fined not more than $500, or imprisoned not more than 1 year, or both."

5. 639 F.2d at 501.

6. *Id.* at 503. The fifth amendment provides in relevant part that no one "shall be compelled in any criminal case to be a witness against himself . . . ." U.S. CONST. amend. V.

At the pre-trial hearing, defendants alleged not only that the Internal Revenue Service (IRS) prosecuted all tax protestors, but also that it had not recently prosecuted any non-protestors.[7] The IRS investigator stated he knew that defendants were invoking their constitutional rights in response to the investigator's questions.[8] Despite this showing, the Ninth Circuit held that the defendants failed to meet the burden of a selective prosecution claim.

B. Background

Timeliness of Appeal

The concept of finality stems from the late eighteenth century.[9] The final judgment rule, which exists mainly to protect judicial efficiency, at times interferes with an individual's constitutional or statutory rights.[10] Because this rule has caused hardship to some individuals, the Supreme Court, in *Cohen v. Beneficial Industrial Loan Corp.*,[11] announced a collateral order exception to the final judgment rule. Under this rule, an interlocutory order had to meet three criteria to be collateral and thus immediately appealable: (1) the order must fully dispose the question presented; (2) the decision must not be a step

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7. 639 F.2d at 504. The defendants presented evidence that 5,140 people in Arizona filed exempt or excessive W-4 statements, that the IRS scrutinized 1,689 W-4 forms and that 425 individuals also failed to file a 1040 form. The IRS investigated and prosecuted only two cases. The Wilsons were tax protestors but the status of the other prosecuted party was unknown. An exempt or excessive W-4 form exists when an employee claims more tax deductions than are legally allowed. The Government usually identifies § 7205 offenses in conjunction with failing to file a 1040 form. United States v. Oaks, 527 F.2d 937, 939 (9th Cir. 1975), *cert. denied*, 426 U.S. 952 (1976).

8. Although this is not part of the selective prosecution test, it demonstrates that the IRS knew that the Wilsons were protestors before it decided to prosecute. The Wilsons had to allege purposeful discrimination to win a motion to dismiss. *See* United States v. Steele, 461 F.2d 1148, 1152 (9th Cir. 1972).

9. *See* McClay v. Hanna, 4 U.S. (4 Dall.) 160 (1799) (appeal must await a definite decree). The current codification of this concept is at 28 U.S.C. § 1291 (1976) which provides in part: "The courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States . . . except where direct review may be had in the Supreme Court."

10. *See, e.g.*, Cobbledick v. United States, 309 U.S. 323, 328-29 (1940) (due regard for efficiency in litigation must not be carried so far as to deny all opportunity for the appeal contemplated by the statutes). *See also* Comment, *Interlocutory Appeals in Criminal Cases: An Open But Closely Guarded Door*, 66 Geo. L.J. 1163, 1164 (1978) (under sufficiently compelling circumstances a defendant's interest in an immediate appeal may outweigh the interests advanced by the finality rule).

11. 337 U.S. 541 (1949).

toward final disposition of the merits of the case that would merge in the final judgment; and (3) the ruling must involve an important right that would be lost if review had to await final judgment.[12] The Court distinguished a final decision from a final judgment[13] and noted that an appeal will be allowed from a final decision only when justified by special circumstances.[14]

The problem that appellate courts faced was defining special circumstances and deciding whether defendant's interest in immediate review was compelling enough to overcome the heavy judicial bias against interlocutory appeals, especially in criminal cases.[15] In *Stack v. Boyle*,[16] the Supreme Court applied the *Cohen* exception to a criminal case and held an order denying a motion to reduce bail immediately appealable.[17] The Court expressed concern that the presumption of innocence would become meaningless if the defendant were allowed to languish in jail awaiting trial.[18]

In *United States v. Higgins*,[19] the Ninth Circuit held that a pre-trial commitment order was immediately appealable under *Cohen*.[20] The court gave two reasons. First, the defendant's trial may be delayed indefinitely, if not forever, so that the commitment order had a phase of finality in it.[21] Second, the order would never be reviewed on direct appeal after trial.[22] The threat of a defendant languishing in jail or in a mental hospital

12. *Id.* at 545-47.

13. *Id. See also* Stack v. Boyle, 342 U.S. 1, 12 (1951) (Jackson, J., concurring) (although a final judgment is always a final decision, a final decision need not be a final judgment).

14. 337 U.S. at 546. *See also* Abney v. United States, 431 U.S. 651, 663 (1977) (special circumstances in double jeopardy claims justifies the application of the collateral order doctrine).

15. Abney v. United States, 431 U.S. 651, 657 (1977). *See, e.g.*, United States v. MacDonald, 435 U.S. 850, 853 (1978) (rule of finality has particular force in criminal prosecutions); Cobbledick v. United States, 309 U.S. 323, 325 (1940) (considerations of policy against piecemeal review are especially compelling in the administration of criminal justice).

16. 342 U.S. 1 (1951).

17. *Id.* at 6.

18. *Id.* at 4.

19. 205 F.2d 650 (9th Cir.), *cert. denied*, 346 U.S. 870 (1953).

20. *Id.* at 652.

21. *Id.* The *Higgins* court did not hold a pre-trial commitment order immediately appealable because it could not be appealed after the trial, but because an appeal after the trial could not vindicate the right that was allegedly violated. *Id.*

22. *Id.*

without a right to appeal was the Ninth Circuit's major concern.[23] *Higgins* tentatively identified one group of cases that would always be immediately appealable: those where a defendant is threatened with loss of liberty.[24]

The Supreme Court expanded the *Stack* rationale to include loss of a constitutional right in *Abney v. United States*,[25] in which it held an order denying a double jeopardy motion immediately appealable.[26] The *Abney* Court reasoned that the fifth amendment provision against double jeopardy extended to double trials as well as double punishments, and that if an appeal was not allowed before the allegedly unconstitutional second trial, the defendant would have irreparably lost a constitutional right without any opportunity for appellate review.[27] The application of the collateral order rule in its entirety, however, has spawned additional ambiguity in questions about immediate appealability.[28]

In *United States v. MacDonald*,[29] the Supreme Court limited the potential expansiveness of *Abney* by holding that a motion to dismiss an indictment was not immediately appealable when based on a violation of defendant's sixth amendment[30]

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23. *Id.*

24. By its nature, a loss of liberty constitutes irreparable harm. For the standard to use to determine irreparable harm, see Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949). This loss also cannot be vindicated on appeal because confinement is both immediate and irreversible. *See* Stack v. Boyle, 342 U.S. at 12; United States v. Higgins, 205 F.2d at 653.

25. 431 U.S. 651 (1977).

26. *Id.* at 662.

27. *Id.* at 660.

28. The confusion about when the collateral order exception applies is due in part to different language used to articulate the same test. The second criterion in the *Cohen* test states that the pre-trial order must not be merely a step towards resolution on the merits. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. at 546. Instead of demonstrating how a double jeopardy claim is not a step towards resolution on the merits, the *Abney* Court stated that a double jeopardy claim is collateral to the merits in the sense that it has nothing to do with guilt or innocence. 431 U.S. at 659. Almost every pre-trial order is collateral to the merits in this sense, yet not all pre-trial orders are appealable. *See, e.g.*, DiBella v. United States, 369 U.S. 121, 131-32 (1962) (denial of motion to suppress illegal evidence is not immediately appealable). Due to this juxtaposition of language and lack of clear guidance, it has been necessary for the Supreme Court to grant certiorari in a number of these cases. *See, e.g.*, Abney v. United States, 530 F.2d 963 (3d Cir. 1976), *aff'd in part, rev'd in part and remanded*, 431 U.S. 651 (1977); United States v. MacDonald, 531 F.2d 196 (4th Cir. 1976), *rev'd*, 435 U.S. 850 (1978).

29. 435 U.S. 850 (1978).

30. The sixth amendment states: "[T]he accused shall enjoy the right to a speedy

right to a speedy trial.[31] The Court justified its decision on three grounds: (1) the speedy trial claim is heavily dependent on the facts developed at trial; (2) the defendant's constitutional rights did not suffer irreparable harm; and (3) allowing an interlocutory appeal would defeat the policy the speedy trial clause was designed to effectuate.[32] The *MacDonald* Court decided that the irreparable harm criteria was probably the most important factor in assessing the right to an immediate appeal.[33]

In *United States v. Griffin*,[34] the Ninth Circuit read *Abney* expansively and held that an order denying a motion to dismiss an indictment on grounds of vindictive prosecution was immediately appealable.[35] The *Griffin* court stressed the similarities between double jeopardy and vindictive prosecution claims and concluded that the latter fulfilled the *Abney* criteria.[36] The court found that a defendant's rights would be lost irrevocably if appellate review were postponed until the final judgment, because defendant would have to undergo "the personal strain, public embarrassment and expense" inherent in preparing a defense.[37] Unnecessary preparations for a criminal defense, however burdensome, is not what the collateral order exception was designed to accommodate.[38] The *Abney* Court stressed that the harm was not that of being put to trial with its attendant burdens and

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and public trial . . . ." U.S. CONST. amend. VI.

31. United States v. MacDonald, 435 U.S. at 853.

32. *Id.*

33. *Id.* at 856. To qualify for an immediate appeal, the Court stated that, perhaps most importantly, defendant's rights must be significantly undermined if appellate review were postponed until after conviction and sentencing. *Id.*

34. 617 F.2d 1342 (9th Cir.), *cert. denied*, 449 U.S. 863 (1980).

35. *Id.* at 1346. Vindictive prosecution exists when a defendant is reindicted or retried on more severe charges after the defendant exercises a statutory or constitutional right. Blackledge v. Perry, 417 U.S. 21, 27-28 (1974); North Carolina v. Pearce, 395 U.S. 711, 725-26 (1969); United States v. Griffin, 617 F.2d at 1346-47; United States v. Andrews, 612 F.2d 235, 238 (6th Cir. 1979); Jackson v. Walker, 585 F.2d 139, 142 (7th Cir. 1978).

36. 617 F.2d at 1346.

37. *Id.* (quoting Abney v. United States, 431 U.S. at 661). The *Griffin* court quoted *Abney* out of context. *Abney* described the purpose of the double jeopardy clause; it did not create a right not to be tried because of the strain and expense of a criminal trial. Abney v. United States, 431 U.S. at 661.

38. *See* Abney v. United States, 431 U.S. at 663. Special considerations are necessary to justify a departure from the normal rules of finality. Pendent claims must fit within the *Cohen* exception to be immediately appealable. *Id.* Cobbledick v. United States, 309 U.S. 323, 325 (1940) (Bearing the discomforture and cost of a prosecution for a crime even by an innocent person is one of the painful obligations of citizenship.).

difficulties, but rather in being put to trial twice in violation of constitutional protections.[39] Furthermore, the Court noted that a defendant's right would probably be lost irrevocably if an appeal had to await a final judgment.[40] It seems doubtful that the Supreme Court would follow *Griffin* because of the high standards of irreparable harm that the Court utilizes when analyzing a right to an immediate appeal.[41]

Selective Prosecution

In *Yick Wo v. Hopkins*,[42] the Supreme Court stated:

> Though the law itself be fair on its face and impartial in appearance, yet, if it is applied and administered by public authority with an evil eye and an unequal hand, so as practically to make unjust and illegal discriminations between persons in similar circumstances, material to their rights, the denial of equal justice is still within the prohibition of the Constitution.[43]

In *Oyler v. Boles*,[44] the Supreme Court extended this constitutional defense to allow challenges to prosecutorial discretion in a criminal case. The Court applied the traditional equal protection analysis and concluded that the mere exercise of some conscious selectivity is not by itself a constitutional violation.[45] There must be a showing that the selection was based upon an unjustifiable standard such as race, religion or other arbitrary classification.[46]

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39. *See* 431 U.S. at 661 ("[A defendant] will not be forced, with certain exceptions, to endure the personal strain, public embarassment, and expense of a criminal trial *more than once* for the same offense.") (emphasis added). *See also* text accompanying note 34 *supra*.

40. 431 U.S. at 662.

41. *See* note 35 *supra* and accompanying text. *See also* text accompanying note 29 *supra*.

42. 118 U.S. 356 (1886). The defendant, a person of Chinese descent, was convicted under an ordinance prohibiting operation of a laundromat in a wooden building. Defendant's application for a permit to operate was denied while white persons' permits were granted. The Supreme Court reversed defendant's conviction stating that racial discrimination in law enforcement was prohibited by the equal protection clause of the fourteenth amendment. *Id.* at 356-62.

43. *Id.* at 373-74.

44. 368 U.S. 448 (1962).

45. *Id.* at 456.

46. *Id.*

In *United States v. Berrios*,[47] the Second Circuit defined arbitrary classification to include prosecutions based upon the exercise of constitutional rights.[48] The *Berrios* court, however, failed to clearly base its decision upon either the chilling effect selective prosecutions has on free speech, or the notion that prosecution based on defendant's exercise of his constitutional rights was arbitrary. If the *Berrios* court based its decision upon selective prosecution's potential chilling effect on free speech, the court must distinguish between speech and conduct, because free speech is entitled to constitutional protection, while conduct is not.[49] If, however, the *Berrios* court included the exercise of constitutional rights because it is an arbitrary basis of selection for prosecution, then very different issues were presented. When making this claim, a defendant invokes the equal protection component of the fifth amendment.[50] To prevail, a defendant must show that others similarly situated are not being prosecuted for similar conduct and, that the basis for selecting a defendant for prosecution was illegitimate—that is, based on race, religion or other arbitrary classification.[51]

The claim of selective prosecution is an affirmative defense, however, and the defendant bears the burden of proof.[52] If the defendant prevails on this claim, it is uncertain whether he can be reindicted on the same charge or whether the defense is absolute.[53]

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47. 501 F.2d 1207 (2d Cir. 1974).

48. *Id.* at 1211.

49. *See* United States v. O'Brien, 391 U.S. 367, 376 (1968). "[W]hen 'speech' and 'non-speech' elements are combined in the same course of conduct, a sufficiently important governmental interest in regulating the non-speech element can justify incidental limitations on First Amendment freedoms." *Id.*

50. United States v. Peskin, 527 F.2d 71, 86 (7th Cir. 1975), *cert. denied*, 429 U.S. 818 (1976).

51. *See, e.g.*, United States v. Gardiner, 531 F.2d 953, 954 (9th Cir.), *cert. denied*, 429 U.S. 853 (1976); United States v. Peskin, 527 F.2d 71, 86 (7th Cir. 1975), *cert. denied*, 429 U.S. 818 (1976); United States v. Scott, 521 F.2d 1188, 1195 (9th Cir.), *cert. denied*, 424 U.S. 955 (1975); United States v. Berrios, 501 F.2d 1207, 1211 (2d Cir. 1974).

52. *See generally* 19 LOY. L. REV. 318 (1973).

53. *Compare* United States v. Berrigan, 482 F.2d 171, 174 (3d Cir. 1973) (finding of discriminatory enforcement need only result in a dismissal of the charge, not in an acquittal) *with* Younger v. Harris, 401 U.S. 37, 54 (1971) (criminal defendants have a right to be free from prosecutions brought in bad faith) *and* Edelman v. California, 344 U.S. 357, 359 (1953) (dictum) (a defendant could defeat a criminal prosecution that was based on intentional discrimination). *See* United States v. Falk, 479 F.2d 616, 631 (7th Cir. 1973) (Cummings, J., dissenting). If reindictment is allowed, then the prosecution would pass the court's scrutiny merely because the case was stated more discreetly. If reindict-

Despite these uncertainties, the single most important determination in a selective prosecution analysis is the kind of showing required for the defendant to meet his burden. In *United States v. Steele,*[54] the defendant showed that although the Census Bureau knew of at least ten persons who violated the law, the director only chose to prosecute those individuals who had aired their views publicly.[55] The Ninth Circuit held this to be impermissible discrimination and reversed the conviction.[56] The defendant's unique showing explained how he met his burden of proof since there was a *perfect* delineation between protestors and non-protestors.[57] The *Steele* court, however, did not state whether this showing necessarily sustained a claim of selective prosecution, although later Ninth Circuit cases suggest that it does.[58]

In *United States v. Falk,*[59] defendant claimed he was selected from among 25,000 violators and was prosecuted because he actively participated in a draft-counseling movement.[60] He failed to show that the government knew of other violators, or that other violators did not protest against the draft—both of which were essential to sustain his claim of selective prosecution.[61] The *Falk* court relied heavily on the government's deviation from its internal prosecution policy to justify its decision.[62] This deviation raised a suspicion about the prosecutor's motive which the court found sufficient to reverse the defendant's

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ment is not allowed, the defendant violates the law with complete immunity on an uncertain basis. *Id.*

54. 461 F.2d 1148 (9th Cir. 1972).

55. *Id.* at 1152.

56. *Id.*

57. Defendant showed that there were ten violators of the census law. Six were non-protestors who were not prosecuted. Four, including the defendant, were vocal resistors and were prosecuted. *Id.*

58. *See* United States v. Oaks, 527 F.2d 937, 940 (9th Cir. 1975) (defendant must show that others similarly situated generally have not been prosecuted for similar conduct), *cert. denied,* 426 U.S. 952 (1976). *Accord,* United States v. Scott, 521 F.2d 1188, 1195 (9th Cir.), *cert. denied,* 424 U.S. 955 (1975).

59. 479 F.2d 616 (7th Cir. 1973) (Cummings, J., dissenting).

60. *Id.* at 625.

61. *Id.* at 627.

62. *Id.* at 621. The majority quoted at length from a memorandum issued by the Selective Service Director stating guidelines used to initiate proceedings against draft avoiders. They also noted that the Selective Service violated those guidelines when it prosecuted Falk. *Id.*

conviction.[63]

The *Falk* court did not specify the type of statistical showing necessary to establish a defense of selective prosecution. In addition, the court stated that even without the necessary showing, the defense could be established if the deviation from prosecutorial policy suggested that the defendant was being persecuted for his beliefs rather than for his conduct.[64]

The defense of selective prosecution remains a murky area in the law, especially as to how the defense can be established and what effect it has on the ability to prosecute.

C. Court's Analysis

In *United States v. Wilson*, the court faced two issues: (1) whether the court had jurisdiction to hear an interlocutory appeal based on the denial of a motion to dismiss the indictment for improper selective prosecution and (2) whether defendants presented sufficient evidence of a selective prosecution to warrant pre-trial dismissal. The Ninth Circuit held that an order denying a motion to dismiss an indictment on selective prosecution grounds was immediately appealable and that the defendants failed to make the necessary showing to raise the defense.[65]

For appeals purposes, both the selective prosecution and the vindictive prosecution defenses are based on the same considerations. As the *Wilson* court noted, both types of prosecutions are instigated punitively against a defendant in retaliation for the exercise of constitutional rights.[66] Although the specific issue—whether a selective prosecution claim was immediately appealable—was a case of first impression, the *Wilson* court relied so heavily on its previous decision in *Griffin* that the decision broke little legal ground.[67]

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63. *Id. But cf.* Spillman v. United States, 413 F.2d 527, 530 (9th Cir.) (mere deviation from prosecutorial policy could not justify acquittal), *cert. denied*, 396 U.S. 930 (1969).

64. 479 F.2d at 624.

65. 639 F.2d at 502, 504.

66. *Id.* at 502.

67. The *Griffin* decision actually set a precedent that certain challenges to an indictment would be immediately appealable. This decision was the first post-*Abney* claim that fit within the *Cohen* exception. The *Wilson* decision merely followed *Griffin* very

First, the *Wilson* court reasoned that a selective prosecution ruling was a final determination of that issue, similar to a vindictive prosecution ruling.[68] Second, the ruling was not a step towards disposition on the merits as the ruling had nothing to do with whether the defendants filed false withholding forms. Finally, the claim of selective prosecution involved a right to be " 'free from prosecution itself, rather than merely the right to be free from a subsequent conviction.' "[69]

The *Wilson* court declared the proper standard of review to be the clearly erroneous standard.[70] A selective prosecution defense is based on facts developed at the pretrial hearing. The court thought that the selective prosecution test lent itself to the clearly erroneous standard because it is a factual question[71] and involved no novelty to the bench or bar.

The court then unanimously held that the defendants had not made the necessary showing to establish a selective prosecution defense.[72] The defendants' evidence showed that the IRS prosecuted fewer than one half of one percent of those similarly situated to the defendants.[73] Defendants failed, however, to establish that others prosecuted were also protestors.[74] Consequently, the court denied defendants' motion for dismissal.[75] The court stated that had the defendants shown that only protestors were prosecuted, they would have been entitled to a dismissal of the indictment.[76] Subsequently, the court stated that "unless one can show that the tax laws are deployed against protestors in retaliation for the exercise of their rights, a selective prosecution argument will fail"[77] and that "it is to be expected that a disproportionate number of tax protestors will be prosecuted" even though protestors make up a very small per-

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closely but did not set a far reaching precedent.

68. 639 F.2d at 502. *See also* text accompanying note 11 *supra*.

69. 639 F.2d at 502 (quoting United States v. Griffin, 617 F.2d at 1345).

70. 639 F.2d at 503.

71. 19 LOY. L. REV. 318, 325 (1973) (once raised, the defense of discriminatory prosecution presents a question of fact).

72. 639 F.2d at 504.

73. The IRS prosecuted two of 425 violators. *Id.* at 501.

74. *Id.* at 504.

75. *Id.*

76. *Id.*

77. *Id.* at 505.

centage of all violators.[78] This dictum suggests that the Ninth Circuit closely followed the *Steele* rationale that defendants must show perfect delineation between protestors and non-protestors to sustain a defense of selective prosecution.[79]

The *Wilson* court rejected defendants' claim that any deviation from prosecutorial policy established a defense of selective prosecution. Unlike *Falk*, the court claimed that any deviation must be motivated by animus against the defendants because they exercised their constitutional rights.[80] The result is that the court will not consider a deviation from prosecutorial policy suspicious unless defendants first make the necessary statistical showing.

Judge Real, concurring in the result, disagreed with the majority on the appealability issue. He claimed that vindictive prosecution and selective prosecution are based on different considerations.[81] First, the concurrence argued that a vindictive prosecution claim involves " 'running the gauntlet' " twice before an appeal could be taken.[82] The concurrence differentiated vindictive and selective prosecution claims because a selective prosecution claim is not collateral to the merits but instead "requires a court to delve into empirical data not vaguely relevant to guilt or innocence in the very prosecution in which the claim is made."[83] The concurrence felt that a vindictive prosecution claim is entirely collateral to the merits of the instant case[84] in that it involves retaliation against a defendant for exercising a constitutional right in an entirely different case.[85]

The concurrence's second argument was that as a matter of policy the test for determining the validity of a vindictive prosecution claim is simpler than the test for a selective prosecution

78. *Id.* The court stated that thousands of returns may bear further investigation, but protestor's returns provide the strongest cases where willfulness is a part of the cause of action. *Id.*

79. See note 57 *supra* for the delineation between protestors and non-protestors in *Steele.*

80. 639 F.2d at 505.

81. *Id.* (Real, J., concurring).

82. *Id.* (quoting Abney v. United States, 431 U.S. at 662).

83. 639 F.2d at 506.

84. *Id.*

85. *Id. See* cases cited in note 35 *supra.*

claim.[86] The concurrence expressed concern that allowing a challenge to the prosecutor's discretion in selecting a particular defendant was tantamount to sanctioning an appellate court's supervision over the prosecutor's office.[87]

D. Analysis

In *United States v. Wilson,* the Ninth Circuit liberalized the opportunity to take an appeal from an interlocutory order denying a motion to dismiss an indictment. This opportunity will probably be extended to encompass all constitutional challenges to an indictment.

Wilson is part of an unhealthy trend which, if true to prediction, may flood the appellate courts with interlocutory appeals used primarily to delay trial.[88] The Ninth Circuit's approach in *Griffin* and *Wilson* struck the balance too heavily in favor of the defendant with very little justification. The need for efficiency in criminal proceedings is especially acute[89] and should not be disregarded without a compelling reason.

The specific problem with *Griffin* and *Wilson* is that the decisions misconstrued the *Cohen* test[90] as applied in *Abney.*[91] The *Griffin* court stated that the defendant would suffer irreparable harm if put to the expense of a criminal trial because of a vindictive prosecution.[92] Enduring a trial and being convicted of a crime does not constitute irreparable harm even when the con-

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86. *See* United States v. Griffin, 617 F.2d at 1346. The prosecution has a heavy burden "to justify the increase in severity of the alleged charges whenever it has the opportunity to reindict the accused because the accused has exercised a procedural right." *Id.* (citing United States v. Ruesga-Martinez, 534 F.2d 1367, 1369 (9th Cir. 1976)).

87. United States v. Wilson, 639 F.2d at 506.

88. *Id.* at 502. Interlocutory appeals frustrate the speedy trial policy and multiply the work of the court. The court processed 38 interlocutory appeals in a four-month period and noted that few had any merit. *Id.* United States v. Burt, 619 F.2d 831, 838 (9th Cir. 1980) (interlocutory appeals have a disruptive effect on the trial courts).

89. *See* cases cited in note 15 *supra* and accompanying text.

90. See text accompanying note 12 *supra.*

91. The Supreme Court in *Abney* reasoned that a double jeopardy claim was appealable by applying the *Cohen* test as follows: (1) the order was final because the defendant has exhausted all means of avoiding an allegedly unconstitutional trial; (2) the claim was collateral to the merits because it challenged the authority of the government to hail the defendant into court; and (3) the order threatened irreparable harm to defendant's constitutional right because it could not be fully vindicated on appeal. Abney v. United States, 431 U.S. at 659-62.

92. United States v. Griffin, 617 F.2d at 1346.

viction is reversed on constitutional grounds.[93] If enduring an unnecessary trial constituted irreparable harm, then the collateral order exception should apply to the denial of any pre-trial motion. If a defendant is convicted with illegally seized evidence, he is forcibly tried and has to undergo the "personal strain, public embarrassment and expense"[94] of preparing a defense. Practically speaking, a motion to suppress evidence would be immediately appealable. The ruling is final because the evidence will be introduced against the defendant; it is collateral to the main issue before the court, whether the defendant is guilty as charged. Finally, the defendant will suffer irreparable harm because he will have to endure a trial that will later prove unnecessary. The Supreme Court has rejected this argument.[95]

Applying *Griffin's* reasoning to its fullest theoretical limits would totally undermine the final judgment rule and exacerbate the dilatory strategies which impede judicial efficiency.[96] Furthermore, *Griffin* considered challenges to an indictment to be on a higher plane than other types of challenges.[97] Such challenges should not have a preferred status.[98]

The better approach is to limit the *Cohen* test to a showing of irreparable harm, defined as damage to a statutory or constitutional right inflicted upon a defendant which cannot be vindicated on appeal. If the defendant shows irreparable harm, he should have an opportunity to appeal the decision of whether it

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93. *See also* Gilmore v. United States, 264 F.2d 44, 47 (5th Cir.), *cert. denied*, 359 U.S. 994 (1959):

> [Appellate Review must await the end of trial] even though, at the end of that trial, or an appeal from a judgment of conviction, it is ultimately determined that the violation of the constitutional right compels an acquittal. When that is the outcome, the individual may claim in a very real sense to have been subjected to a trial that ought never to have taken place.

Id. (footnote omitted).

94. United States v. Griffin, 617 F.2d at 1346.

95. *See* DiBella v. United States, 369 U.S. 121, 131-32 (1962) (denial of motion to suppress illegal evidence is not immediately appealable).

96. *See* Comment, *supra* note 10, at 1167.

97. 617 F.2d at 1348.

98. *See* Gilmore v. United States, 264 F.2d 44, 47 (5th Cir.), *cert. denied*, 359 U.S. 994 (1959). "At least so long as a criminal trial is pending, review of such matters, as for example, unlawful search and seizure, unlawful arrest, unlawful detention, *unlawful indictment*, unlawful confession must await the trial and its outcome." *Id.* (emphasis added).

is collateral to the main issue. The other two criteria provide an inadequate basis for analysis and appear not to make much of a difference.[99]

To alleviate the burden of interlocutory appeals, the Ninth Circuit should drop vindictive and selective prosecution claims from consideration for an immediate appeal because any harm done to a defendant can be corrected on appeal. For those orders which remain immediately appealable, the court should enact a system of concurrent jurisdiction[100] so trial can progress while the appellate court reviews the defendant's claim. This system would protect the defendant's right to an immediate appeal without as much potential for abuse as a strategy for delay.

The difficulties inherent in establishing a selective prosecution claim are far more problematic. The problem with the *Falk* test is that it encourages public agencies to publish vague and general guidelines for prosecution or forego publishing them at all. Consequently, the prosecutor has much more unbridled discretion—an unhealthy sign in a free society.[101] The *Steele* test is so stringently construed that it may have written itself out of existence.[102] Even Yick Wo could not have met the stringent *Steele* standard because, although all Chinese persons were prosecuted, one non-Chinese person was also prosecuted.[103]

Another problem is defining the line between permissible and impermissible selection. If all but one of those prosecuted are protestors, the protestors cannot raise the defense of selective prosecution. If the law is enforced exclusively against

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99. *See* note 28 *supra*.

100. *See* United States v. Dunbar, 611 F.2d 985, 988-89 (5th Cir.), *cert. denied*, 447 U.S. 926 (1980). The Fifth Circuit has devised a system to expedite interlocutory appeals. First, the district court decides if the motion to dismiss is frivolous. If it is, the trial continues while the defendant appeals the decision. The appellate court considers these appeals on an expedited basis and merely decides if the appeal has merit. If it does, the trial is halted while the appellate court considers the issues raised in the appeal. *Id.*

101. *See* K. DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY 225 (1969) (Prosecutors should be required to structure their discretion to make it less arbitrary.).

102. It is very unusual when a defendant can show that no other violator who did not exercise his or her constitutional rights was prosecuted. The *Wilson* majority noted that the defendant in *Steele* was the *only one* in a Ninth Circuit case to successfully raise the defense of selective prosecution. United States v. Wilson, 639 F.2d at 505.

103. Yick Wo v. Hopkins, 118 U.S. 356, 359 (1886).

protestors, each protestor can raise the defense,[104] even if the prosecutor shows that the selection was based on limited resources or other permissible criteria. Such a small quantitative change does not justify such a divergent result. The policies and considerations that allow a prosecutor to consciously select protestors for prosecution[105] exist equally whether he prosecuted many, most, or all protestors. Conversely, this same discretion allows a prosecutor to refuse to prosecute non-protestors without endangering the prosecution of the protestors.[106]

Drawing inferences from statistics is a risky endeavor, especially in selective prosecution cases, because it is well understood that a high degree of selectivity is necessary to enable the prosecutor to perform his duties.[107] Deciding between permissible and impermissible selectivity cannot be done solely by statistical analysis. The solution as to how this constitutional interest will be protected is elusive. Courts seem willing to use statistics as the best approximation of a prosecutor's motive without a face-to-face confrontation between the defendant and the prosecutor, reliance on pure speculation, or direct supervision of the prosecutor's office, all of which have tremendous problems.

The showing necessary to raise the selective prosecution de-

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104. The protestors may ultimately lose, but according to the holding in *Wilson*, they get the benefit of an immediate appeal.

105. *See* United States v. Oaks, 527 F.2d 937, 940 (9th Cir. 1975), *cert. denied*, 426 U.S. 952 (1976).

> "The awareness by the I.R.S. of the fact that the defendant publicly explained in detail how he had frustrated the tax withholding laws and urged others to follow his example may well have influenced the I.R.S. in selecting him as a person whose prosecution would have relatively great deterrent value. Such selective prosecution is deemed reasonable and appropriate."

Id. (quoting the district court finding without citation).

106. *See* United States v. Choate, 619 F.2d 21, 23 (9th Cir.), *cert. denied*, 449 U.S. 951 (1980) (quoting United States v. Manno, 118 F. Supp. 511, 515 (N.D. Ill. 1954)):

> [C]itizens are entitled to equal protection of the law but these decisions do not hold that citizens are entitled to equal protection *from* the laws. The fact that not all criminals are prosecuted is no valid defense to the one prosecuted . . . . [T]he administration of such a matter lies in the discretion of the prosecuting attorney.

Id. (emphasis in *Manno*).

107. *See* United States v. Choate, 619 F.2d 21, 23 (9th Cir.), *cert. denied*, 449 U.S. 951 (1980); United States v. Wilson, 639 F.2d at 505.

fense should be relaxed to make it meaningful and yet protect the prosecutor's discretion from unwarranted intrusion. This conflict can be resolved without jettisoning either policy. The analytical problem that exists in all selective prosecution claims is that a primary question is left unanswered: Is the basis for this prosecution arbitrary? This threshold question must be answered before the traditional equal protection analysis can be utilized coherently. In tax protest cases the answer is emphatically no.[108] There are many good reasons for prosecuting protestors: (1) there is a greater deterrence effect, (2) there is a better chance of conviction, (3) their violations are flagrant and willful, and (4) they encourage others in civil disobedience.

If the threshold question of arbitrariness is answered in the negative, the analysis should cease. At this point it should not matter what statistical showing the defendant makes, even if he shows that only protestors are prosecuted. An allegation that a defendant is being prosecuted for protesting is meaningless in this context. The reply to the allegation is simply that, although a defendant is being prosecuted for protesting, there is a reasonable basis for selectivity based on the reasons enumerated above.

This should not be interpreted to mean that the exercise of constitutional rights should never be an impermissible classification, but only that the exercise of constitutional rights is not always an arbitrary basis for a selection for prosecution. For example, if the tax laws were selectively enforced against Communists, the standard would clearly be arbitrary and the defense of selective prosecution should be allowed.

This prior determination of arbitrariness would obviate the necessity of such a difficult showing required to establish the defense. Once it has been determined that the selection of a defen-

108. *See* United States v. Stout, 601 F.2d 325, 328 (7th Cir.) (an active tax protestor who draws attenion to himself may be specially prosecuted), *cert. denied*, 444 U.S. 929 (1979); United States v. Gardiner, 531 F.2d 953, 954 (9th Cir.) (it is not surprising to prosecute violations of the tax laws that are most flagrant), *cert. denied*, 429 U.S. 853 (1976); *accord*, United States v. Oaks, 527 F.2d 937, 940 (9th Cir. 1975) (selection based on advocacy of civil disobedience is appropriate as it has great deterrent value), *cert. denied*, 426 U.S. 952 (1976); United States v. Scott, 521 F.2d 1188, 1195 (9th Cir.), *cert. denied*, 424 U.S. 955 (1975).

dant is arbitrary, then all the defendant should be required to show is a general pattern of selective enforcement on this basis, not the total absence of other prosecutions. The defendant would still have to meet the requirements of the equal protection analysis, but these requirements can be sensitized to detect when a pattern of arbitrary selection is taking place.

The statistical showing needed to trigger an investigation into the defense is unknown. Perhaps the best formulation is if prosecution of the arbitrarily selected group far exceeds their representation in the pool of all violators. The prosecution would then be given an opportunity to rebut the charge by showing that the defendant's conduct was more flagrant than others or that they were randomly selected.

Finally, this test would better serve both policies than the current test. Once the prosecutor established that the basis for selection was permissible, there would be no hearing because statistics would be irrelevant. Thus, the prosecutor's discretion would be amply protected without burdensome judicial supervision. On the other hand, the defendant would have the benefit of an easier burden of proof once he establishes that his selection was arbitrary.

There is a tremendous need for judicial legislation in this area. Both of these conflicting policies must be accommodated by a single test because they both serve important societal interests. The rights of a defendant to non-arbitrary law enforcement need not be sacrificed on the altar of prosecutorial discretion.

Jeff Kirk

II. OTHER DEVELOPMENTS IN TAXATION

In other cases last term, the Ninth Circuit upheld IRS summonses for business records of the Swiss subsidiaries of American firms even though compliance may expose the subsidiaries to criminal liability in Switzerland, permitted the surviving corporation in a triangular reorganization to carry back its post-merger losses without special limitations, and addressed the novel issue of the proper tax treatment of rights acquired by a professional sports team.

A. Enforcing Internal Revenue Service Summons

In *United States v. Vetco, Inc.*,[1] the Ninth Circuit held that the Swiss-United States Tax Treaty does not preclude the Internal Revenue Service (the IRS) from using summonses to obtain business records of the Swiss subsidiaries of American firms despite possible criminal liability in Switzerland for such compliance. Applying a balancing approach, the court further determined that any contrary Swiss interest is outweighed by a strong American interest in collecting taxes from and prosecuting tax fraud by its own nationals operating through foreign subsidiaries.[2]

Vetco is an American-based corporation which manufactures offshore drilling equipment. Vetco International, A.G. (VIAG) is Vetco's wholly-owned Swiss subsidiary. Vetco is subject to subpart F of the Internal Revenue Code (the Code) for the reporting of VIAG's income.[3]

The IRS asserted that, by using a Swiss corporation as a middleman to ship its products indirectly to VIAG for sale, Vetco attempted to avoid subpart F income since VIAG's income no longer was derived from transactions with a related corporation outside Switzerland.[4]

When Vetco failed to voluntarily disclose relevant records, the IRS issued summonses to Vetco, Vetco's accountants (DH & S) and its attorneys. Vetco ordered its attorneys and accountants not to comply.[5]

The district court determined that the summonses had been issued for proper purposes and, after a special hearing on the effect of Swiss law, ordered Vetco and DH & S to produce their

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1. 644 F.2d 1324 (9th Cir. 1981) (per Skopil, J. the other panel members were Nelson, J. and East, D.J., sitting by designation), *cert. denied*, 50 U.S.L.W. 3465 (U.S. Dec. 8, 1981).

2. *Id.* at 1333.

3. *See* I.R.C. §§ 951-964 (CCH 1979). Subpart F of the Code requires that income of a controlled foreign corporation be reported on the Federal Income Tax return of the parent corporation if ten percent of the subsidiary's income resulted from transactions with related corporations located outside the country of the subsidiary's incorporation. I.R.C. § 954(b)(3)(a) (amended 1975).

4. 644 F.2d at 1326.

5. *Id.* at 1327.

Swiss records.[6] However, the court failed to enter findings of fact or conclusions of law with respect to the summonses.[7] Vetco and DH & S subsequently appealed the order and contempt sanctions imposed for noncompliance.[8]

On appeal,[9] the appellants argued that compliance with the

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6. *Id.* The district court held that Vetco's attorneys were not required to produce DH & S's tax survey.

7. *Id.*

8. *Id.*

9. Three other issues were raised on appeal. First, appellants argued that the district court erred in failing to enter findings of fact and conclusions of law. With respect to this issue, the court noted that "[e]ven if Rule 52(a) of the Federal Rules of Civil Procedure requires findings and conclusions in summons enforcement and contempt proceedings, the district court could have modified that requirement by issuing an order" pursuant to FED. R. CIV. P. 82(a)(3). 644 F.2d at 1327. Consequently, the court summarily concluded that there was no rational reason for the district court to carry out such a formality. *Id. See* Brunswick Corp. v. Doff, 638 F.2d 108, 110-11 (9th Cir. 1981).

Vetco also argued that the Swiss-United States Tax Treaty precluded the use of IRS summonses to obtain business records held in Switzerland and that IRS regulations provide that treaty information-exchange provisions are the sole means of obtaining such records. 644 F.2d at 1328.

Article XVI of the Treaty provides in relevant part:

> (1) The competent authorities of the contracting States shall exchange such information (*being information available under the respective taxation laws of the contracting States*) as is necessary for carrying out the provisions of the present Convention or for the prevention of fraud or the like in relation to the taxes which are the subject of the present Convention . . . . *No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.*
>
> . . . .
>
> (3) In no case shall the provisions of this Article be construed so as to impose on either of the contracting States the obligation to *carry out administrative measures at variance with the regulations and practices of either contracting State or which would be contrary to its sovereignty, security or public policy or to supply particulars which are not procurable under its own legislation or that of the State asking application.*

Convention on Double Taxation of Income, Sept. 27, 1951, United States-Switzerland, 2 U.S.T. 1751, 1760-61, T.I.A.S. No. 2316 (emphasis added). The court determined that none of these provisions precluded the IRS from issuing summonses to gather information. 644 F.2d at 1328.

Vetco also argued that IRS regulations which provide for treaty information-exchange provisions are the exclusive means of obtaining such records. Vetco based its contention on ¶ 42(10)(10).1(4) of the Internal Revenue Manual which provides in pertinent part that "[t]he Articles of the respective tax conventions determine the extent of the information obtainable in Treaty countries." II AUDIT, INTERNAL REVENUE MANUAL (CCH) ¶ 42(10)(10).1(4). However, such provisions are "not the exclusive means of ob-

IRS summonses would result in violation of Article 273 of the Swiss Penal Code which makes unlawful the disclosure of manufacturing or business secrets to a foreign government.[10] Appellants relied primarily on *Societe Internationale v. Rogers*,[11] in which the Supreme Court stated that "fear of criminal prosecution constitutes a weighty excuse for non-production, and this excuse is not weakened because the law preventing compliance are those of a foreign sovereign."[12]

In *Societe Internationale*, a Swiss company sued for recovery of property seized by the United States government pursuant to the Trading with the Enemy Act. The Swiss government enjoined the plaintiff who was accused of conspiring with a Swiss banking firm from obtaining the Swiss banks' business records.[13]

The *Vetco* panel noted that *Societe Internationale* "did not erect an absolute bar to summons enforcement and contempt sanctions whenever compliance is prohibited by foreign law,"[14] and that *Societe Internationale* specified that its ruling did not apply "to every situation where a party is restricted by law from producing documents over which it is otherwise shown to have

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taining information where the treaty does not so provide and where the foreign source is a subsidiary of an American corporation." 644 F.2d at 1329. Thus, the court found the issuance of summonses not in violation of either the Swiss-United States Tax Treaty or IRS regulations regarding information-exchange provisions.

Regarding the third issue addressed on appeal, DH & S contended that it was denied due process since the district court's production order sought "all" records described in the summons and the order to show cause had only specified those documents held in Switzerland. On this issue, the court noted that the district court's order encompassed only those documents located in Switzerland. Thus, DH & S was not denied due process. *Id.* at 1333.

10. Whoever makes available a manufacturing or business secret to a foreign governmental agency or a foreign corporation or private enterprise or to an agent of any of them, shall be subject to imprisonment and in grave cases to imprisonment in a penitentiary.

The imprisonment may be combined with a fine.

StGB art. 273. *See* Swiss Federal Attorney v. A., 98 BGE IV 209 (1972) ("Business secret" includes "all facts of business life to the extent that there are interests worthy of protection in keeping them confidential.").

11. 357 U.S. 197 (1958).

12. *Id.* at 211.

13. *Id.* at 201.

14. 644 F.2d at 1329.

control."[15] Rather, the determination depends on "the circumstances of a given case."[16]

The court, in ruling that the instant action was not controlled by the holding in *Societe Internationale,* distinguished the latter case on several grounds. First, the plaintiff in *Societe Internationale* made extensive good faith efforts to comply with the discovery request, whereas Vetco made no such effort.[17] Second, in *Societe Internationale,* it was the Swiss government not a private corporation that sought to enjoin the plaintiff from complying with the summons.[18] Third, the Court in *Societe Internationale* determined that production would violate Swiss law,[19] whereas in *Vetco* there was no comparable finding.[20] Fourth, the document requested in *Societe Internationale* was a civil discovery order rather than an IRS summons issued pursuant to an investigation leading to potential criminal conduct.[21]

After distinguishing *Societe Internationale,* the court balanced the competing interests as required by *In re Westinghouse Electric Corp. Uranium Contracts Litigation,*[22] to determine whether foreign illegality ought to preclude enforcement of the IRS summonses.[23]

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15. 357 U.S. at 205-06.
16. *Id.* at 206.
17. *Id.* at 201.
18. *Id.* at 200.
19. *Id.* at 204.
20. 644 F.2d at 1330.

> We have spent I don't know how many months now going into the question of Swiss law, and this threat of penal sanctions. Based on what I have before me at this point, I am now of the view that the threat of criminal sanctions by Switzerland is not as real as was initially suggested to me to be.

Id. n.7. (quoting district court hearing of Nov. 15, 1979).

21. *Id.* at 1330. According to the *Vetco* court, such IRS summonses "serve a more pressing national function than civil discovery." *Id.*
22. 563 F.2d 992, 997 (10th Cir. 1977).
23. Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as

> (a) vital national interests of each of the states,
> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,

After a careful analysis of these balancing factors, the court concluded that the United States had a compelling interest in obtaining the documents to collect taxes and prosecute tax fraud by its own nationals operating through foreign subsidiaries, while Switzerland had a small interest in insisting that the documents not be produced.[24] Furthermore, the court was unconvinced that production of the documents in question would impose a significant hardship on appellants.[25] The court reasoned that had Vetco kept a copy of such records as required by Code section 964,[26] the instant controversy would never have arisen. Moreover, appellants failed to cite a single case concerning prosecution for compliance with a court order enforcing an IRS summons.[27]

B. Carryback of Post-Merger Losses in Triangular Organization

In *Bercy Industries, Inc. v. Commissioner*,[28] a case of first impression, the court addressed the issue of whether a subsidiary corporation involved in a triangular merger can carry back its post-merger losses to offset pre-merger income of the transferor corporation, where the subsidiary was a mere shell before the merger.[29] Reversing the tax court, the Ninth Circuit held that New Bercy, the surviving corporation, could under section 381(b)(3) of the Code carry back its post-reorganization losses without special limitations.

(c) the extent to which the required conduct is to take place in the territory of the other state,

(d) the nationality of the person, and

(e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

Restatement (Second) of Foreign Relations Law § 40 (1965).

24. "Switzerland's only interest is in protecting the privacy of its non-consenting domiciliaries. This interest is further diminished where the party seeking the records is the IRS, which is required by law to keep information confidential." 644 F.2d at 1331.

25. *Id.* at 1331-32.

26. Pursuant to I.R.C. § 964(c)(CCH 1979), an American corporation is required to keep records respecting its controlled foreign corporation sufficient to determine whether subpart F tax is due. 644 F.2d at 1332.

27. 644 F.2d at 1332.

28. 640 F.2d 1058 (9th Cir. 1981) (per Trask, J.; the other panel members were Nelson and Solomon, J.J.).

29. *Id.* at 1059.

In 1965, Bercy Industries incorporated. Three years later, Beverly Enterprises established Beverly Manor as its subsidiary shell corporation. In 1970, Bercy Industries (Old Bercy) was acquired by Beverly Manor through a triangular merger.[30] Beverly Manor then changed its name to Bercy Industries (New Bercy). The shareholders of Old Bercy exchanged their stock for shares of the parent corporation, Beverly Enterprises. The stock in Old Bercy was then cancelled.[31] New Bercy was expected to profit as did Old Bercy, but instead suffered a loss. In reliance on the carry-back provision of Code section 172,[32] New Bercy attempted to offset this loss against the net operation income of Old Bercy. The tax court disallowed the loss carryback and New Bercy appealed.

The Commissioner argued that Code section 381(b)(3) reflects a policy of not permitting loss carryback when the legal and economic identity of the corporation has been substantially altered.[33] The Commissioner further argued that because Congress specifically identified two circumstances in which loss carrybacks would be permitted under section 381(b)(3),[34] the Commissioner argued that "if Congress had also intended to permit carrybacks in a triangular merger involving a shell corporation, it would have specifically mentioned this circumstance as well."[35]

After a careful examination of legislative history and statu-

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30. "This is a transaction in which a subsidiary corporation acquires another corporation by using the stock of the subsidiary's parents as consideration for the acquisition." *Id.* n.2.

31. *Id.* at 1059.

32. A corporation which incurs a net operating loss may carry this loss back three tax years, or forward seven tax years, to offset net operating income earned during those years. I.R.C. § 172.

33. 640 F.2d at 1060.

34.
> In two important areas . . . the problem of allocating the loss is not involved, and it is suggested in such cases, at least, there should be no limit on carrybacks. One is the case of reincorporation of the same corporation in a different state, or upon the expiration of its charter. Another instance is that of the wholly-owned subsidiary which is liquidated into its parent, which parent suffers a net operating loss in the following year.

Hearings on H.R. 8300, Before the Senate Finance Comm., 83d Cong., 2d Sess. 404, 404 (1954).

35. 640 F.2d at 1061.

tory structure, the panel decided that Congress had been "preoccupied with post-reorganization allocation problems when it enacted the loss carryback restriction."[36] The court also reasoned that when section 381(b)(3) was enacted in 1954, "the Code did not permit a corporation to use its parent's stock as consideration for the acquisition of another corporation's assets in a tax-free reorganization."[37] Thus, the use of shells in effecting corporate reorganizations was not yet recognized. However, the use of parent stock as consideration for a corporate acquisition was sanctioned by amendments in 1968 and 1971.[38]

The Court agreed with the Second Circuit which stated in *Aetna Casualty & Surety Co. v. United States*,[39] that Congress intended to prohibit post-reorganization carryback losses "only when such a carryback would entail complex problems of post-reorganization allocation."[40] Even assuming the Commissioner had correctly stated the congressional policy regarding subsection (b)(3), the court was unconvinced "that a material change in identity resulted from the reorganization here at issue. The reorganization involved only one set of operating assets, one set of books, and one tax history."[41] Because New Bercy operated the same commercial business as did Old Bercy, "[t]he indisputable fact is that the same business generated both the income and the loss."[42] Thus, the court held that New Bercy could utilize the loss carryback provision of section 381(b)(3), even though the subsidiary corporation was a mere shell before the merger, since no material change resulted in Old Bercy's identity.[43]

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36. With respect to the enactment of subsection (b)(3) of section 381, the legislative history shows that Congress was concerned with a complex accounting problem—deciding how a post-reorganization loss should be allocated between the acquiring corporation and the transferor corporations, and, therefore, how much of the loss should be carried back to offset each entity's income in the preceeding three tax years.

Id. at 1060-61.

37. *Id.* at 1061.

38. Act of Oct. 22, 1968, Pub. L. No. 90-621, § 1(a), 82 Stat. 1310-11 (triangular mergers); Act of Jan. 12, 1971, Pub. L. No. 91-693, § 1(a), 84 Stat. 2077 (reverse triangular mergers).

39. 568 F.2d 811, 819, 822, 824 (2d Cir. 1976).

40. 640 F.2d at 1062.

41. *Id.*

42. *Id.*

43. *Id.*

C. The Treatment of Professional Sports Teams

In *First Northwest Industries of America v. Commissioner*,[44] the Ninth Circuit addressed a novel issue regarding the proper tax treatment of a professional sports team, the Seattle Supersonics. In 1970, the National Basketball Association (the NBA) expanded the league by selling three newly-created expansion teams.[45] The taxpayer owned the Seattle Supersonics and received an equal share of the expansion proceeds along with thirteen other NBA owners. At issue was the proper tax treatment of those expansion proceeds.

The taxpayer acquired association rights[46] when he pur-

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44. 649 F.2d 707 (9th Cir. 1981) (per Wright, J.; the other panel members were Anderson, J. and Taylor, D.J., sitting by designation).

45. The NBA expanded in 1970 by selling new teams in Portland, Buffalo, and Cleveland. *Id.* at 708.

46. The association rights acquired are as follows:

> 1. The right to participate in a special expansion draft in which it could select 15 veteran players from ten existing teams;
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> 2. The right to participate in the 1967 college draft;
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> 3. The right to participate in all post-1967 annual NBA college drafts;
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> 4. The right to participate in NBA basketball by competing against other teams, including the right to retain all home-game receipts;
>
> 5. The exclusive right to exhibit NBA basketball within a 75-mile radius of Seattle;
>
> 6. The right to an equal share (with other team owners) of all revenues derived from national broadcasting of NBA games;
>
> 7. The exclusive rights for local broadcasting of Sonics' games;
>
> 8. The right to an equal share of revenues derived from NBA promotional and merchandising activities;
>
> 9. The right to an equal share of revenues derived from NBA playoff and all-star games;
>
> 10. The right to enjoy the benefits of NBA reputation and goodwill;
>
> 11. The rights (and obligations) of participating in a system which establishes within the NBA of priority rights to players and the bargaining rights of each team with respect to its own players;
>
> 12. The right to share equally with proceeds from future NBA expansions;
>
> 13. Other rights, benefits, and obligations attendant to being a member of the NBA.

Id. at 707-08.

Not at issue was the tax court's treatment of taxpayer's rights to share in the 1968

chased the Supersonics in 1967. The tax court labelled the other rights acquired in the purchase "basic nonterminable rights" possessed by all NBA team owners.[47] The tax court noted that a proportion of the nonterminable rights were transferred to the expansion teams[48] and allowed the taxpayer to subtract from his portion of the amount realized an equivalent proportion of his cost in acquiring these rights.

On appeal, the Commissioner argued that the rights transferred were not original, but were new rights "created" by the existing teams.[49] As such, the Commissioner asserted the taxpayer was precluded from subtracting the proportionate cost of these rights from his amount realized in computing capital gains.[50]

The Ninth Circuit reversed, concluding that "some, but not all, of the rights acquired by taxpayer in 1967 were partially transferred to the new owners."[51] The court agreed with the Commissioner that taxpayer's "franchise" rights—the right to participate in the NBA, the exclusive right to local broadcasting, and its exclusive right to exhibit NBA basketball within a seventy-five-mile radius of Seattle—were not transferred.[52] Therefore, the taxpayer's cost in acquiring these nontransferrable rights were improperly included by the tax court in calculating the taxpayer's basis.

With respect to the taxpayer's remaining "nonterminable" rights, the court concluded these were existing rather than

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expansion proceeds and the right to participate in the expansion draft. The tax court had properly determined that these rights had a limited useful life which the taxpayer was entitled to amortize. 649 F.2d at 708. For an analysis of this aspect of the decision, see Note, *Federal Income Tax—Amortization and the Expansion Sports Franchise*, 54 WASH. L. REV. 827 (1979).

47. 649 F.2d at 708.

48. "The tax court reasoned that, because there were 14 owners prior to the 1970 expansion, taxpayer had a 1/14 interest in these rights. After expansion, it had a 1/17 interest. Hence, a proportion of its original interest had been transferred to the expansion teams." *Id.*

49. " '[T]he rights obtained by the new teams were not siphoned off from the existing teams but rather were entirely new rights created when the league approved the expansion plan and granted the franchises.' " *Id.* (quoting Appellant's Opening Brief at 10).

50. 649 F.2d at 708-09.

51. *Id.* at 709.

52. *Id.* at 709-10.

newly-created rights and were proportionally transferred to the expansion teams. However, since the tax court had failed to determine the cost of these rights, the *First Northwest* panel remanded the case. The critical question on remand, as framed by the court, is whether there is sufficient evidence to allocate the cost of these rights between those which were transferred and those retained by the taxpayer.[53]

53. *Id.* at 710.