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Summaries: Tax Law

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TAX LAW

THE NINTH CIRCUIT SUGGESTS ALTERNATIVE STANDARD FOR DEFICIENCY NOTICES

I. INTRODUCTION

In *Meridian Wood Products, Inc. v. United States* and *Lenton v. United States*,¹ the Ninth Circuit ruled the limitations period on the Internal Revenue Service's (IRS) assessment of a tax deficiency ran from the date specified in the extension agreement between the taxpayer and the IRS, not from the date the deficiency notice was mailed to the taxpayer. Therefore, an assessment of deficiency mailed after the expiration of the extension agreement but prior to the date specified in the agreement was timely.

The court also held that the taxpayer must substantiate business expense deductions by a preponderance of the evidence,² and that appellate review of the trial court's determination of whether or not the taxpayer has met the burden of proof is subject to the clearly erroneous standard.³

1. 725 F.2d 1183 (9th Cir. 1984) (per Alarcon, J.; the other panel members were Fletcher, J. and Jameson, D.J., sitting by designation). These two cases were consolidated on appeal.

2. I.R.C. §274(d) (1982) provides in part:

No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to any activity which is of a type generally considered to constitute entertainment . . . unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment . . . , (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained

Id.

3. 725 F.2d at 1190.

II. THE COURT'S ANALYSIS

The Ninth Circuit initially focused on the timeliness of the IRS deficiency assessments against the taxpayers and began its analysis by looking at the language of the extension agreement.⁴ The agreement contemplated that a notice of deficiency, if sent prior to October 15, 1979, would extend the limitations period for 150 days. Plaintiffs asserted the extension agreement was ambiguous because the clause, "the time for assessing the tax shall be further extended" did not clearly refer to the October 15, date.⁵

4. Plaintiffs Harry and Colleen Lenton and Meridian Wood Products, Inc., entered into an agreement with the IRS, pursuant to §6501 of the Internal Revenue Code (the "Code"). The agreement stated in part:

The amount(s) of any Federal Income Tax due under any return(s) made by or on behalf of the above named taxpayer(s) for the period(s) ended October 31, 1974 and October 31, 1975 . . . under existing or prior revenue laws, may be assessed at any time on or before October 15, 1979, except that if a notice of deficiency in tax for any such period(s) is sent to the taxpayer(s) on or before that day, then the time for assessing the tax shall be further extended for the period in which the assessment is prohibited and for 60 days thereafter.

Id. at 1185.

I.R.C. §6501(c)(4) (1982) provides in part:

Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title . . . both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon.

Id.

The agreement extended the time in which the IRS could assess any federal income tax due under returns filed by the plaintiffs for the periods ended October 31, 1974 and October 31, 1975. The agreement had an expiration date of October 15, 1979, however if the IRS mailed a notice of deficiency to the taxpayer prior to the expiration date, the IRS was given an additional 150 days to assess any tax deficiency. A notice of deficiency restricts the ability of the IRS to assess and collect an asserted tax deficiency. I.R.C. §6213 (a) (1982) provides in part:

Within 90 days . . . after the notice of deficiency authorized in section 6212 is mailed . . . the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided . . . no assessment of a deficiency in respect of any tax imposed . . . shall be made . . . until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day . . . period . . . , nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.

Id.

5. I.R.C. § 6501(c)(4) (1982).

The Ninth Circuit rejected plaintiff's contention that the 150 day extension period commenced on May 29, 1979, the date the notice of deficiency was sent.⁶ In rejecting this argument the court relied on *Ramirez v. United States*, where a similar argument was rejected as unreasonable.⁷ The court pointed out that the extension agreement between the IRS and the Lenton's, like the one in *Ramirez*, only set forth one expiration date. The plain meaning of the agreement was the sending of a notice of deficiency would extend the limitations period beyond the October 15, date.⁸ Since the plaintiffs did not file a petition with the Tax Court, the total limitations period was 150 days commencing on October 15, 1979. Therefore, the November 4 and 5 assessments were timely.⁹

The Ninth Circuit also rejected plaintiff's argument because even if the limitations period commenced on May 29, 1979, the November 4 and 5 assessments were timely by virtue of sections 6501 and 6503.¹⁰ The court considered the agreement between the IRS and the taxpayers within the meaning of §6501 and

6. 725 F.2d at 1186.

7. 538 F.2d 888 (Ct. Cl.), *cert. denied*, 429 U.S. 1024 (1976). In *Ramirez* the extension agreement had a June 30, 1972 expiration date but if a notice of deficiency was sent prior to that date, then the time for making an assessment was extended beyond that date for 150 days. *Id.* at 891. The taxpayer asserted that the phrase "that date" referred to the date on which the deficiency notice was sent not the expiration date. The court dismissed the assertion noting the agreement set forth only one date which referred to an assessment, June 30, 1972. The court said "[it is unreasonable] to assert that the phrase 'that date' . . . referred to two separate dates, without any hint that it did in the language itself." *Id.*

8. 725 F.2d at 1187. The IRS mailed a notice of deficiency to the plaintiffs on May 29, 1979. The plaintiffs did not file a petition with the Tax Court to have the deficiency redetermined. Thereafter on November 4 and 5, 1979, the IRS assessed a tax deficiency against the plaintiffs. *Id.*

9. *Id.* at 1186.

10. Section 6501 provides for a three year statute of limitations after a return is filed in which any tax may be assessed. I.R.C. §6501 (a) (1982). An exception to the three year statute of limitations is for written agreements that extend the time in which an assessment can be made. I.R.C. §6501 (c)(4) (1982). Section 6503 provides: "[T]he running of the period of limitations provided in section 6501 . . . on the making of assessments . . . in respect of any deficiency . . . shall . . . be suspended for the period during which the Secretary is prohibited from making the assessment . . . and for 60 days thereafter." I.R.C. §6503(a)(1) (1982).

The period which the Secretary is prohibited from making an assessment is determined by §6213(a). If a notice of deficiency is mailed to a taxpayer in the United States then the Secretary is prohibited from assessing any deficiency until 90 days after the notice is sent. I.R.C. §6213(a) (1982), *supra* note 4. The combined effect of these two statutes is to prohibit any assessment until 150 days after the deficiency notice is mailed.

therefore subject to the suspension provision of §6503.¹¹

The court next addressed the deductions for travel and entertainment expenses taken by Meridian. A taxpayer must substantiate every element of every expenditure by records or through their own statements corroborated by other evidence in order to deduct entertainment and travel expenses under section 274 and section 162.¹²

Plaintiffs argued that although their records did not show the business purpose or the business relationship of the payee to the taxpayer, they had substantially complied with the requirements of § 274 because their records established the date, the amount, and the payee for the various expenditures.¹³ Plaintiffs also argued that since the IRS did not rebut this evidence the judgment of the district court should be reversed.¹⁴

Initially, the panel noted plaintiffs' reliance on *Caratan v. Commissioner*,¹⁵ was inappropriate because plaintiffs failed to introduce evidence contrary to the findings of the IRS and failed to meet their burden of showing the merits of their claim by a preponderance of the evidence.¹⁶

11. 725 F.2d at 1188.

12. *Dowell v. United States*, 522 F.2d 708, 714 (5th Cir. 1975), *cert. denied*, 426 U.S. 920 (1976). The elements of the expenditures which must be substantiated are: amount; time and place; business purpose, and; business relationship to the taxpayer of the person entertained. I.R.C. §274(d) (1982). I.R.C. §162(a) (1982) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." *Id.*

13. The IRS audited Meridian's returns for the years 1974 and 1975. The audit disclosed that Meridian's records of expenditures, which had been deducted as business expenses, failed to indicate the business purpose of the expenditure, the persons entertained and the date of each expense as required by §274 of the Code. Vouchers submitted by Harry Lenton for reimbursement of these expenses, also failed to comply with the substantiation requirements of §274. Consequently, for purposes of the IRS audit, Lenton prepared an addendum to the vouchers attempting to explicitly describe the business purposes of the expenditures. The IRS disallowed these deductions and Meridian appealed to the district court. The district court ruled that Meridian had failed to introduce sufficient evidence of the business purpose for the expenditures and thus failed to substantiate the expenses as required under [274.] 725 F.2d at 1190.

14. 725 F.2d at 1189.

15. 442 F.2d 606 (9th Cir. 1975). In *Caratan* the Ninth Circuit stated that a presumption of correctness existed in favor of an IRS determination regarding the disallowance of a deduction. *Id.* at 608. However, where there was testimony or other evidence sufficient to support a contrary finding, "the presumption of correctness disappeared." *Id.*

16. 725 F.2d at 1189-90 (citing *Rockwell v. Commissioner*, 512 F.2d 882 (9th Cir.

In reviewing the evidence offered by Meridian to support his claim for deductions, the Ninth Circuit noted the claims were unsupported by receipts or other documentation and that aggregate amounts of expenditures were deducted rather than individual expenditures. Since the trial court's findings were not clearly erroneous, the Ninth Circuit deemed them to be correct.¹⁷

The other issue addressed by the panel was the lower court's conclusion that the deductions previously disallowed by the IRS constituted a constructive dividend to the taxpayer. The test for a constructive dividend is two fold: the expenses must be non-deductible to the corporation and they must represent some economic gain or benefit to the taxpayer.¹⁸

The Ninth Circuit affirmed the finding that the reimbursements were constructive dividends to Colleen Lenton because of the economic benefit of reimbursement for travel expenses. Since Harry Lenton failed to prove the reimbursements were business expenses,¹⁹ the disallowed deductions were also considered to be constructive dividends.²⁰

III. CONCLUSION

In *Meridian Wood Products*, the Ninth Circuit has sug-

1971)). In *Rockwell* the court held the taxpayer was required to rebut the initial presumption in favor of the IRS and then still had the ultimate burden of persuasion. *Id.* at 885. Meridian asserted that vouchers prepared by Harry Lenton for Meridian to reimburse him were sufficient to satisfy the third element under §274, business purpose of the expenditure. The district court rejected this assertion because the vouchers and addendum failed to show the origins of the expense and specifically explain the individual expenses. The Ninth Circuit held the district court's determination whether the taxpayer had presented persuasive proof to satisfy the substantiation requirements of §274 was a factual one, reviewable under the clearly erroneous standard. 725 F.2d at 1190 (citing *Paal v. Commissioner*, 450 F.2d 1108 (9th Cir. 1971)). In *Paal* the appellant-taxpayer did not introduce any objective evidence or third party testimony establishing the elements of §274 and thus did not persuade the trial court of its claim for deductions for entertainment expenses. The *Paal* court considered the trial court's findings to be factual and could not be overturned unless clearly erroneous. *Id.* at 1110.

17. 725 F.2d at 1190.

18. *Id.* at 1191 (citing, *Palo Alto Town & Country Village Inc. v. Commissioner*, 565 F.2d 1388, 1391 (9th Cir. 1977)). In *Palo Alto* the Ninth Circuit overturned a Tax Court determination that a corporation's disallowed expenses automatically become constructive dividends to an owner of the corporation. *Id.*

19. See *supra* note 13.

20. 725 F.2d at 1191.

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gested utilization of section 6503 as an alternative basis for determining the timeliness of deficiency assessments. Section 6503 suspends the general statute of limitations for 60 days beyond the period in which the Secretary is prohibited from assessing a deficiency (90 days). Thus, even if the limitations period were to commence on the date the deficiency notice was mailed, the provision would suspend the assessment limitations period for 150 days. By suggesting this alternative method the court has eliminated any possible doubt as to the commencement of the statute of limitations for the assessment of a tax deficiency.

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