Golden Gate University Law Review

Volume 17
Issue 1 *Ninth Circuit Survey*

Article 12

January 1987

Tax Law

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TAX LAW

GOOD FAITH AND THE FRAUDULENT CONVEYANCE ACT

I. INTRODUCTION

In *Mayors v. Commissioner*[1], the Ninth Circuit applied California law and held that the transfer of a house between cohabitants in exchange for past services was supported by fair consideration.[2] Even though the transferor was insolvent, the parties' good faith belief in the existence of the transferee's rights, rendered the transfer not fraudulent.[3] Therefore, the transferee was not liable for the transferor's tax liability.[4]

II. FACTS

In 1971, appellant, Susan Mayors ("Mayors") worked as a secretary/receptionist in the office of Dr. Joseph A. Averna ("Averna")[5]. Mayors and Averna became emotionally involved and began living together, but did not marry.[6] While living together Mayors and Averna did not hold themselves out as a married couple and kept their financial affairs separate.[7] Mayors continued to work in Averna's office as a secretary/book-keeper and X-ray technician, and she also kept house for him.[8] Averna did not pay Mayors for her household services but gave her funds for basic living expenses and for special needs as they

1. 785 F.2d 757 (9th Cir. 1986) (per Wiggins, J.; the other panel members were Anderson, J. and Pregerson, J.).
2. *Id.* at 761.
3. *Id.*
4. *Id.*
5. *Id.* at 758.
6. *Id.*
7. *Id.* at 759.
8. *Id.* at 758.

arose.[9]

In June, 1973, Mayors gave birth to their daughter Antoinette. In anticipation of the birth of Antoinette, Averna bought a residence at 1970 Avon Lane, Spring Valley, California for $32,500.00.[10] The deed conveyed the property to Averna, "a single man."[11] In 1977 Averna refinanced the property for $52,000.00, giving a deed of trust as security for the property and signing a note making him personally liable for the repayment.[12]

In December, 1978, Mayors and Averna separated.[13] At the time of their separation, Mayors and Averna reached an oral agreement regarding division of their property; Averna would transfer the Avon Lane property to Mayors and would provide $500.00 per month child support.[14]

On February 20, 1979, Averna transferred the property to Mayors by quit-claim deed, with no cash consideration.[15] At the time of the transfer, the property was worth $90,000.00 and was encumbered by the 1977 deed of trust with a remaining loan balance of $51,450.00.[16] At the time of the transfer, Averna was insolvent[17] to the extent of $69,627.93.[18]

Averna made the first four payments on the loan after the transfer in lieu of the child support payments.[19] He failed to make the next two loan payments. Mayors then paid the delinquent installments, and the penalties to bring the account cur-

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9. *Id.* at 758-59. Averna paid her below market wages for her work in his office. *Id.*

10. *Id.* at 758.

11. *Id.*

12. *Id.*

13. *Id.* Mayors and Antoinette continued to live at the Avon Lane residence up to the time of trial. *Id.*

14. *Id.* at 759.

15. *Id.*

16. *Id.* As a result, Mayors received a transfer of equity of $38,550.00, while Averna remained personally liable on the loan to the bank. *Id.*

17. Insolvency as defined in the Cal. Civ. Code provides in relevant part: "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." Cal. Civ. Code § 3439.02(a) (West 1970).

18. Mayors v. Commissioner, 785 F.2d at 759 (9th Cir. 1986).

19. *Id.*

rent.[20] Mayors made all subsequent payments and put the promissory note in her own name.[21] Averna made additional child support payments directly to Mayors totaling $699.00, then stopped completely.[22] Mayors thereafter threatened to sue Averna for the discontinued child support payments.[23]

Subsequently, on April 12, 1982, after unsuccessfully attempting to collect tax deficiencies on Averna's 1977 and 1978 personal income tax, the Commissioner of Internal Revenue issued Mayors a notice that she was liable as a transferee for payment of Averna's tax liability.[24]

Mayors petitioned the U.S. Tax Court, arguing that the transfer of the house was in settlement of a pre-existing debt, which constituted fair consideration.[25] The Tax Court rejected her argument finding that the transfer was not supported by fair consideration and thus, that Mayors was liable for Averna's tax liabilities.[26] The Tax Court reasoned that because Mayors failed to prove the value of services rendered, she did not demonstrate that Averna was obligated to her under the principles relating to non-marital partners,[27] as ennunciated in *Marvin v. Marvin.*[28] Mayors appealed to the Ninth Circuit.

III. BACKGROUND

Section 6901(a) of the Internal Revenue Code provides a procedure for the collection of an existing tax liability from an asset transferred to a third party.[29] It is intended to prevent tax-

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20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* The Commissioner's determination of Mayor's liability was based on 26 U.S.C. § 6901(a) of the Internal Revenue Code, *see infra* note 29 and accompanying text.
25. Mayors v. Commissioner, 785 F.2d at 759-61 (9th Cir. 1986).
26. Mayors v. Commissioner, para. 84,401 T.C.M. (P-H 1984).
27. *Id.*
28. 18 Cal. 3d 660, 134 Cal. Rptr. 815, 557 P.2d 106 (1976), *see infra* note 48 and accompanying text.
29. 26 U.S.C. § 6901(a) (1982), states:

> (a) Method of Collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes

payers from avoiding payment of taxes through a transfer of assets that the Internal Revenue Service could otherwise attach to satisfy tax deficiencies.[30]

State law governs the extent of a transferee's actual liability under section 6901(a) as denoted in *Commissioner v. Stern*.[31] Under California Civil Code section 3439.04, a conveyance made by a person who is, or will be thereby rendered insolvent is fraudulent as to other creditors, such as the I.R.S., without regard to his actual intent, if the conveyance is made without fair consideration.[32] In *Headen v. Miller*,[33] the court stated that a fraudulent conveyance to creditors may be set aside.[34] Fair consideration as defined in the California Civil Code is that which is given for property, which when exchanged is a fair equivalent, or not disproportionately small to that property, with the underlying notion of good faith.[35]

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with respect to which liabilities were incurred:
(1) Income, estate and gift taxes.
(A) Transferees. The liability, at law or in equity, of a transferee of property—
(i) of a taxpayer in the case of a tax imposed by subtitle A (relating to income taxes)
. . . .

Id.

30. Mayors v. Commissioner, 785 F.2d at 759 (9th Cir. 1986).

31. 357 U.S. 39, 42-45 (1958). In determining the liability of a transferee of property under § 311 of the 1934 Journal Revenue Code, the Supreme Court that the existence and extent of liability should be determined by state law. *See, e.g.*, Eyler v. Commissioner, 760 F.2d 1129, 1132 (11th Cir. 1985).

32. Cal. Civ. Code § 3439.04 (West 1970), states: "Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration." *Id.*

33. 141 Cal. App. 3d 169, 190 Cal. Rptr. 198 (1983).

34. *Id.* at 172, 190 Cal. Rptr. at 200. The court stated the general rule in California that a conveyance by an insolvent person of an asset to another without fair consideration is in fraud of creditors. The creditors' remedies depend upon whether the claim has matured and include: setting the conveyance aside. *Id.*

35. Cal. Civ. Code § 3439.03 (West 1970), provides:
Fair consideration is that given for property or obligation:
(a) When in exchange for such property, or obligation, as a fair equivalent, and in good faith, property is conveyed or an antecedent debt is satisfied, or
(b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in the amount not disproportionately small as compared with the value of property, or obligation obtained.

Id.

Good faith in California is discussed in *Bank of California v. Virtue & Scheck, Inc.*,[36] a fraudulent conveyance case also involving fair consideration under California Civil Code section 3439.03.[37] The *Scheck* court noted that the essential issue was whether the entire transaction was enacted in good faith.[38] If the parties in good faith believed that the promise was binding, then the consideration was valid.[39] The mere possibility that the promise may not have been legally enforceable was irrelevant to the essential issue of good faith.[40]

In California there are several precedents supporting the general proposition that forbearance to exercise a legal right is sufficient consideration. In *Coldwell Banker & Co. v. Pepper Tree Office Center Associates*,[41] the court so held.[42] The *Coldwell* court also noted that basic contract law recognizes that forbearance to exercise a legal right is sufficient consideration.[43] In *Healy v. Brewster*,[44] it was held that forbearance to press a claim or promise to forbear may be sufficient consideration even though the claim was wholly ill-founded.[45] In *Silver v. Shemanski*,[46] the court held that a compromise of a doubtful right is a sufficient foundation for an agreement.[47]

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36. 140 Cal. App. 3d 1026, 190 Cal. Rptr. 54 (1983). In determining the relative rights of a corporation's creditors to proceeds resulting from liquidation, the court held that the conveyance of a mortgage from the corporation to its president was fraudulent as to creditors. *Id.* at 1026, 190 Cal. Rptr. at 54.

37. *See supra* note 35 and accompanying text.

38. 140 Cal. App. 3d 1026, 1040, 190 Cal. Rptr. 54, 64 (1983).

39. *Id.*

40. *Id.* at 1041, 190 Cal. Rptr. at 64.

41. 106 Cal. App. 3d 272, 165 Cal. Rptr. 51 (1980) *rev'd in part, on other grounds*, 178 Cal. App. 3d 960, 224 Cal. Rptr. 76 (1986). (Broker sought commissions for leases between building operator and tenants; held, agreement was modified as to preclude broker from obtaining commissions on such leases). *Id.*

42. *Id.* at 280, 165 Cal. Rptr. at 56.

43. *Id.*

44. 251 Cal. App. 2d 541, 59 Cal. Rptr. 752 (1967). The court held that the promise of a general contractor to pay an earthwork subcontractor the reasonable value of the extra work required by mutual mistake as to soil composition, was supported by adequate consideration where the subcontractor relied upon such a promise in forbearing recission and in performing such extra work. *Id.* at 541, 59 Cal. Rptr. at 752.

45. *Id.* at 551, 59 Cal. Rptr. at 758.

46. 89 Cal. App. 2d 520, 201 P.2d 418 (1949). The court held valid a compromise agreement that settled a dispute over property disposed of in accordance with decedent's will. *Id.* at 520, 201 P.2d at 418.

47. *Id.* at 531, 201 P.2d at 426.

That a nonmarital partner has enforceable property rights against his or her former partner was established in California in *Marvin v. Marvin*.[48] A non-marital partner may recover for the reasonable value of household services rendered if he or she can show that the services were rendered with the expectation of a monetary award.[49] The California Supreme Court in *Marvin* based its opinion on the principle that adults who voluntarily live together are as competent as any other persons to contract respecting earnings and property rights.[50]

Under 26 U.S.C. section 6902(a), the Commissioner has the burden of proving the liability of a transferee.[51] Once the Commissioner establishes a *prima facie* case of fraudulent conveyance by showing that the transfer was made by one who was insolvent,[52] the transferee then bears the burden of proving that the transfer was for fair consideration.[53]

IV. THE COURT'S ANALYSIS

The Ninth Circuit reversed the Tax Court and remanded with directions to enter judgment for Mayors.[54] The Ninth Circuit found that the Tax Court had misconstrued the nature of Mayors' claim that there was adequate consideration by focussing on proof of the actual value and viability of the *Marvin*-type[55] claim Mayors may have had against Averna.[56] The Ninth Circuit stated that whether Mayors actually had an enforceable right against Averna was irrelevant if Mayors and Averna be-

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48. In Marvin v. Marvin, 18 Cal. 3d 660, 684-85, 134 Cal. Rptr. 815, 831-32, 557 P.2d 106, 122-23 (1976), the court held that a non-marital partner may recover in *quantum meruit* for the reasonable value of household services rendered less the reasonable value of support received. *Id.*

49. *Id.*

50. *Id.* at 674, 134 Cal. Rptr. at 825, 557 P.2d at 116.

51. 26 U.S.C. § 6902(a) (1982) states: "Burden of proof — In proceedings before the Tax Court the burden of proof shall be upon the Secretary or his delegate to show that a petitioner is liable as a transferee of property of a taxpayer . . . . " *Id.*

52. *See supra* note 17.

53. Kirkland v. Risso, 98 Cal. App. 3d 971, 977-78, 159 Cal. Rptr. 798, 801-02 (1980). The *Kirkland* court held that the transferee, brother, had the burden of proof to establish that the conveyance was supported by fair consideration, after having conceded that the transferor was insolvent. *Id.*

54. Mayors v. Commissioner, 785 F.2d at 761-62 (9th Cir. 1986).

55. *See supra* note 48 and accompanying text.

56. *Mayors*, 785 F.2d at 761.

lieved in good faith that she had such a right and that the transfer was made to satisfy it or in exchange for her forbearance from enforcing it.[57]

The Ninth Circuit focused on basic contract law concepts to support its holding that the Tax Court misconstrued the nature of Mayors' claim.[58] The court examined two aspects of contract law which are deemed sufficient consideration in California: a good faith belief that one has an enforceable right and that a transfer is made in exchange for it; and in the alternative, forbearance from enforcing such right.[59]

To support the good faith concept, the Ninth Circuit relied on *Bank of California v. Virtue & Scheck, Inc.*.[60] The *Scheck* court held that the essential issue was good faith and that whether the promise was legally enforceable was irrelevant.[61] The Ninth Circuit interpreted California law to mean that the parties' good faith belief in the existence of a valid claim was the essential issue and not whether Mayors actually had a valid claim.[62] Therefore, the Ninth Circuit disregarded the Tax Court's analysis of the validity of Mayors' claim altogether, as the validity was irrelevant.[63]

The essential issue for the Ninth Circuit was whether Mayors and Averna believed in good faith that Mayors had an enforceable right against Averna.[64] The Ninth Circuit found good faith belief by showing that there was no evidence of bad faith. It held that the lack of an overt threat to sue Averna or the filing of a suit did not undermine the good faith of the transfer.[65] In fact the court thought it was commendable that Mayors was able to arrive at a division of property with Averna without resort to threats or litigation.[66]

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57. *Id.*

58. *Id.* Mayor's claim was that she had a valid enforceable right against Averna, (as a non-marital partner was held to have in Marvin v. Marvin, *see supra* note 48) and that the transfer of the Avon Lane property was made to satisfy such a right. *Id.* at 760-61.

59. Mayors v. Commissioner, 785 F.2d at 761 (9th Cir. 1986).

60. *See supra* note 36 and accompanying text.

61. *See supra* note 36 and accompanying text.

62. *Mayors*, 785 F.2d at 761.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

The Ninth Circuit continued its good faith analysis finding that the Commissioner's claim that Mayors never intended to give up her rights under *Marvin* was unsupported by the record.[67] Apparently, the Commissioner reasoned that if Mayor's did not intend to give up her rights, the transfer of property (the agreement) was not supported by consideration as Mayors exchanged nothing in return.[68] Alternatively, the Tax Court reasoned that if she did not intend to give up her rights then the agreement was not made in good faith.[69] However, the Ninth Circuit noted that Mayors considered suing Averna only after he stopped making the agreed child-support payments,[70] thereby demonstrating that Mayors considered taking action to enforce the original agreement.[71] Apparently, the Ninth Circuit reasoned that Mayors did intend to give up her rights in the original agreement and therefore that it was made in good faith. The Ninth Circuit also noted that the Tax Court specifically found that Averna and Mayors understood that the transfer was in exchange for past services rendered by Mayors.[72] Evidently the court reasoned that by believing that Mayors had property rights, the exchange of the property for these rights must have been made in good faith. Mayors claimed that the Tax Court erred in finding that the transfer of the Avon Lane property was without fair consideration.[73] She noted that the Tax Court acknowledged her *Marvin*-type claim and was willing to assume that any uncompensated services rendered by her to Averna were rendered with the expectation of compensation.[74] Mayors argued to the Ninth Circuit that the transfer of the house was in settlement of this pre-existing debt, and so constituted fair consideration.[75] The Ninth Circuit did not have to consider this argument as it deemed that the validity of Mayors' claim was irrelevant to the fairness of the consideration, because of their good faith belief in its validity.[76]

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67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.* at 760.
74. *Id.*
75. *Id.*
76. *Id.* at 761.

The second aspect of contract law that the court discussed was that Mayors' forbearance from enforcing that right would also be sufficient consideration.[77] The court's analysis of this aspect went no further than citing many California precedents.[78]

V. CRITIQUE

The result in *Mayors v. Commissioner* is supported by California law.[79] The Ninth Circuit cited *Bank of California v. Virtue & Scheck, Inc.*,[80] to support its interpretation of the good faith element of fair consideration.[81] The *Scheck* court defined good faith as an integral part of fair consideration.[82] It held that if the parties believed in good faith that the promise was binding, then the consideration was valid.[83] The Ninth Circuit directly followed the *Scheck* court's holding, focusing on the good faith of the parties in their agreement and transfer of property.[84]

The *Scheck* court's decision is the only appellate court decision in California which has directly considered and interpreted the importance of good faith within California Civil Code section 3439.03. Thus, it supports the Ninth Circuit's interpretation of California law. However, California law remains vague as to precisely what constitutes good faith.

California Civil Code sections 3439-3439.12 represent California's adoption of section 3 of the Uniform Fraudulent Conveyance Act.[85] Many other states have also adopted the Uniform Fraudulent Conveyance Act and have interpreted good faith as an element of fair consideration.[86]

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77. Mayors v. Commissioner, 785 F.2d at 761 (9th Cir. 1986), *see supra* notes 41, 44 and accompanying text.

78. *Id.* at 761, *see supra* notes 41, 44 and accompanying text.

79. *See supra* notes 36-46 and accompanying text.

80. 140 Cal. App. 3d 1026, 190 Cal. Rptr. 54 (1983), *see supra* text accompanying notes 36-40.

81. *Mayors*, 785 F.2d at 761.

82. *Scheck*, 140 Cal. App. 3d 1026, 1035, 190 Cal. Rptr. 54, 60 (1983).

83. *Id.* at 1040, 190 Cal. Rptr. at 64.

84. *Mayors*, 785 F.2d at 761.

85. Uniform Fraudulent Conveyance Act § 3, 7A U.L.A. (West 1985).

86. Twenty-six states have adopted the act. For a list of the adopting states and corresponding state law, *see* 7A U.L.A. § 3 (West Supp. 1985). For a discussion of the act, including the good faith element, *see The Uniform Fraudulent Conveyance Act in Pennsylvania*, 5 U. Pitt. L. Rev. 161 (1939); *Application of the Uniform Fraudulent*

Bank of California v. Virtue & Scheck, Inc.,[87] contains the requested jury instructions which define good faith.[88] These instructions are the identical words used by the Supreme Court of Washington in *Tacoma Association of Credit Men v. Lesler*,[89] when defining good faith in the context of the Uniform Fraudulent Conveyance Act.[90] The Washington Supreme Court discussed three factors in defining good faith; "(1) An honest belief in the propriety of the activity in question; (2) no intent to take unconscionable advantage of others; and (3) no intent to, or knowledge of the fact the activity in question will hinder, delay, or defraud others."[91] A Washington appellate court following *Tacoma* stated that if any of these factors are absent, lack of good faith is established.[92] Also, the *Tacoma* court continued; "[G]ood faith is to be determined by looking to the intent behind or the effect of a transaction, rather than to its form."[93]

The first factor in the *Tacoma* court's definition of good faith is an honest belief in the propriety of the activity in question.[94] An agreement made in the face of separation after Averna and Mayors had been living together seven years may or may not have been made honestly. It could depend on whether they

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Conveyance Act, 46 Harv. L. Rev. 404 (1933); for cases that discuss the element good faith, *see* Smith v. Whitman, 39 N.J. 397, 189 A.2d 15 (1963) (that transfers of debtors' leases were not made for fair consideration under New York law in view of lack of good faith, and thus, transfers made at the time debtors were insolvent); Lucking v. Barker, 274 Mich. 103, 264 N.W. 306 (1936) (good faith of grantors and grantees is not determined by mere form of conveyance, and does not come into question unless rights of third parties are cut off); Huber v. Coast Inv. Co., 30 Wash. App. 804, 638 P.2d 609 (1981) (fair consideration, under statute allowing plaintiff to have conveyance set asside if he can demonstrate lack of fair consideration in exchange, includes concept of good faith); Tacoma Ass'n of Credit Men v. Lesler, 72 Wash. 2d 453, 433 P.2d 901 (1967) (whether there has been good faith and whether there has been a fraudulent conveyance, is to be determined by looking to intent behind or effect of transaction rather than to its form).

87. 140 Cal. App. 3d 1026, 190 Cal. Rptr. 54 (1983).

88. *Id.* at 1035, 190 Cal. Rptr. at 60.

89. 72 Wash. 2d 453, 458, 433 P.2d 901, 904 (1967).

90. Washington adopted the Uniform Fraudulent Conveyance Act in 1945. 7A U.L.A. § 3 (West Supp. 1986).

91. *Tacoma*, 72 Wash. 2d at 458, 433 P.2d at 904 (1967).

92. Sparkman & McLean Co. v. Derber, 4 Wash. App. 341, 347, 481 P.2d 585, 591 (1971), the court following *Tacoma*, stated: "[I]f any one of these factors is absent, lack of good faith is established and the conveyance fails." *Id.*

93. Tacoma Ass'n of Credit Men v. Lesler, 72 Wash. 2d at 458, 433 P.2d at 904 (1967).

94. *Id.*

were separating in a hostile atmosphere. A hostile atmosphere may tend to lead to an agreement more likely to have been reached in an arms-length transaction, and fairly bargained for. But the contrary is also likely, that the agreement was made simply to help Averna evade his creditors.

The fact that there was a child involved, and that the agreement was reached through Mayors' attorney does help support the conclusion that the agreement was made in an arms-length transaction.

Mayors testified that she considered suing Averna only after he stopped making the agreed child-support payments.[95] The Ninth Circuit stated that this merely showed that Mayors considered taking action to enforce the original agreement, not that Mayors did not intend the original transfer to be binding.[96] The Court also noted that the Tax Court specifically found that Averna and Mayors understood that the transfer was in exchange for past services.[97]

These points may demonstrate that the agreement was honestly made between Averna and Mayors as they tend to illustrate a bargained for exchange. Thus, the first element of good faith does have support in the record, but without a specific discussion and analysis by the court, it is difficult to conclude that the agreement was honestly made.

The second and third elements of good faith; that there was no intent to take unconscionable advantage of others and that there was no intent to, or knowledge that the transfer would hinder, delay, or defraud others, are not supported in the record nor are they discussed by the court. Thus, the Ninth Circuit departs from the better approach; fully defining and analyzing good faith as interpreted in the context of the Uniform Fraudulent Conveyance Act.[98]

The Ninth Circuit only considered good faith in the context

95. Mayors v. Commissioner, 785 F.2d at 761 (9th Cir. 1986).

96. *Id.*

97. *Id.*

98. Tacoma Ass'n of Credit Men v. Lesler, 72 Wash. 2d 453, 433 P.2d 901 (1967) as defined by the Washington Supreme Court. *See supra* text accompanying note 91.

of the agreement between Averna and Mayors. The California forbearance and good faith cases[99] and the Restatement[100] do support the consideration in the agreement between Averna and Mayors as being valid either in their "good faith" belief of Mayors' rights or in the forbearance from enforcing those rights. But good faith belief as applied in the transaction between Averna and Mayors, and basic contract, law does not take into account third party creditors, such as the I.R.S., that may have been affected by the transfer of property from Averna to Mayors when Averna was insolvent.

Good faith should be determined with respect not only to Mayors and Averna, but to third party creditors as well.[101] In *Hansen v. Cramer*,[102] the California Supreme Court held that what constitutes fair consideration under the Fraudulent Conveyance Act must be determined from the standpoint of creditors.[103] The *Cramer* court holding supports the theory that creditors should be contemplated when analyzing fair consideration. The *Tacoma* court's definition of good faith does just that by looking at the intention of the parties as it affects others.[104]

The Ninth Circuit used good faith in the strict sense as it applies to consideration in basic contract law. It would be sounder public policy to also consider good faith as against creditors as well, thus protecting creditors and promoting confidence in contracts which in turn contributes to a healthier economy. This definition of good faith supports the purpose behind section 6901(a)[105] of the Internal Revenue Code which is to prevent

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99. *See supra* notes 36-47 and accompanying text.

100. The *Restatement* in relevant part, states:

> (1) Forbearance to insert the surrender of a claim or defense which proves to be invalid is not consideration unless;
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> (a) The claim or defense is in fact doubtful because of uncertainty as to the facts or the law; or
>
> (b) The forbearing or surrendering party believes that the claim or defense may be fairly determined to be valid.

Restatement (Second) of Contracts, § 74 (1979).

101. *See supra* text accompanying note 92.

102. 39 Cal. 2d 321, 245 P.2d 1059 (1952). Where plaintiff creditor successfully saught to set aside a deed given in consideration for cancellation of an antecedent debt owed by defendant. *Id.* at 321, 245 P.2d 1059.

103. *Id.* at 324, 245 P.2d at 1061.

104. *See supra* text accompanying note 92.

105. 26 U.S.C. § 6901(a) (1982), *see supra* text accompanying note 29.

taxpayers from avoiding payment of taxes through transfer of assets.[106] Transfers that are not made in good faith would be set aside. Over time, this result would prevent a potentially insolvent transferor from attempting to avoid his obligations by transfering away his assets to the detriment of his creditors. Thus, enabling these creditors to rightfully satisfy obligations that are due them.

VI. CONCLUSION

The Ninth Circuit's decision that the transfer was made for fair consideration may have been the same even with a fully developed analysis of good faith. However, that conclusion is not certain. The public policy of promoting confidence in contracts through the protection of creditors is encouraged by a strict interpretation of good faith when in the context of the Fraudulent Conveyance Act.

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106. *See supra* text accompanying note 30.

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TAX SUMMARY

THE COMMISSIONER AND SUBSTANCE TRIUMPH OVER FORM

I. INTRODUCTION

In *Bryant v. Commissioner*,[1] the Ninth Circuit held that: the taxpayers' basis in their beaver investment must be limited to the fair market value of the beavers and not the stated contract price;[2] the evidence supported the Tax Court's determination of fair market value;[3] and the assessment of additional tax for negligent failure to report investment tax credit was proper.[4]

II. FACTS

Taxpayers Bryant, Hartman, Webber, and Wohl invested in domestic beavers during the 1970's. The beavers were maintained by ranchers on already existing ranches on behalf of the investors.[5] The investor was given a certificate for each of his beavers and was able to identify his animals by tatoos.[6] The ranchers charged the beaver owners a fee for feed and maintenance of their beavers.[7]

All taxpayers except Bryant paid $3,500 per proven pair of

1. 790 F.2d 1463 (9th Cir. 1986) (per Wiggens, J.; the other panel members were Skopil, J. and Fletcher, J.).
2. *Id.* at 1466.
3. *Id.* at 1467.
4. *Id.* at 1468.
5. *Id.* at 1464.
6. *Id.* The investors were also given financial projections for the proposed beaver investment. The projections showed substantial income tax losses during the first six or seven years. Taxable income was shown for each year after the seventh. *Id.*
7. *Id.*

beavers and $2,400 per nonproven pair.[8] In each case, the taxpayer agreed to make a cash down payment and to give a promissory note for the balance of the contract price.[9] The contracts included an option that after the fourth year the principal could be repaid in beavers, and that the value of the beavers used to repay the notes would be equal to the original stated contract price for the beavers.[10] As a result of this option the taxpayers were only required to make cash payments of about 12% of the stated contract price, and the remainder could be paid in beavers.[11] At the same time that these taxpayers were purchasing beavers for $1,200 and $1,750 per animal, the sellers were purchasing beavers for prices ranging between $16 and $250 per animal.[12]

All of the taxpayers, except Byrant, repaid with beavers as soon as their contracts allowed them to.[13] Each taxpayer took depreciation and interest deductions, and the investment tax credit, using a tax basis in the beavers equal to the stated contract price.[14] Several of the taxpayers' beavers died or were disposed of during the period in question, however the taxpayers did not report investment tax credit recapture during this period.[15]

The Commissioner disallowed part of the depreciation and interest deductions and determined that the investment tax credit should be recaptured.[16] He determined that some of the taxpayers had additional capital gains and income from the sale of beavers, and also assessed an additional tax against the taxpayers for negligent failure to report investment tax credit recapture.[17]

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8. *Id.* Bryant paid $3,250 per proven pair (those that have produced offspring) and $2,250 per nonproven pair (those that have not produced offspring). *Id.*

9. *Id.* The notes bore interest at a stated rate and required annual principal payments of a stated amount. *Id.*

10. *Id.*

11. *Id.* Bryant actually paid $7,450 on a $52,000 stated contract price; Hartman: $7,344 on a $61,200 stated contract price; Webber: $14,000 on a $109,200 stated contract price; and Wohl: $6,900 on a $68,800 stated contract price. *Id.*

12. *Id.* at 1465.

13. *Id.* at 1464. Bryant continued to repay with money. *Id.*

14. *Id.* at 1464-65.

15. *Id.* at 1465.

16. *Id.*

17. *Id.* The additional assessment was under 26 U.S.C.§ 6653(a) (1982). *See infra*

The Tax Court upheld the Commissioner's determination of deficiencies in the claimed federal tax liabilities of these taxpayers.[18] The Tax Court denied the investment in beavers to the extent the stated contract price exceeded the fair market value of the beavers.[19] Therefore, the court held that the taxpayers' basis in the beavers and the amount of indebtedness were limited to the fair market value of the beavers.[20] The Tax Court disallowed the taxpayers' depreciation and interest deductions and required recapture of their investment tax credit to the extent that each was not supported by the basis or debt as determined by the Tax Court.[21] The Tax Court also affirmed the Commissioner's assessment of an addition to each taxpayer's tax for negligent failure to report investment tax credit recapture.[22] The taxpayers consolidated their cases and appealed to the Ninth Circuit.

III. THE COURT'S ANALYSIS

The Ninth Circuit affirmed the Tax Court's decision. The court first analyzed the basis of the investment, since the allowable depreciation and investment tax credit depend on the tax basis.[23] The general rule is that the basis of property for tax purposes is the cost of the property.[24] However, the Ninth Circuit noted that courts have determined that in certain circumstances when a taxpayer's stated cost for an asset does not reflect its true economic value, the stated cost will be ignored for purposes of determining the basis of the asset.[25]

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note 49.

18. *Bryant*, 790 F.2d at 1465.

19. *Id.*

20. *Id.*

21. *Id.* The Tax Court determined the fair market value of the beavers to be $200 per proven beaver, $137 per nonproven beaver, and $29 per yearling. *Id.*

22. *Id.*

23. Bryant v. Commissioner, 790 F.2d 1463, 1465 (9th Cir. 1986) (citing 26 U.S.C.§§ 38, 46(c)(1)(A), and 167(g)).

24. *Bryant*, 790 F.2d at 1465 (citing 26 U.S.C. § 1012 (1982)).

25. *Bryant*, 790 F.2d at 1465 (citing Estate of Franklin v. Comm'r, 544 F.2d 1045 (9th Cir. 1976) (basis does not include that portion of nonrecourse debt that unreasonably exceeds the value of the underlying property); Lemmen v. Comm'r, 77 T.C. 1326, 1348 (1981) (basis does not include that portion of the stated purchase price of an asset that exceeds the value of the asset, if peculiar circumstances induce the taxpayer to pay more for the asset than its value)).

The Ninth Circuit agreed with the Tax Court's application of the rationale used in *Lemmen v. Commissioner*.[26] In *Lemmen*, the Tax Court rejected the use of the purchase price of the cattle for basis purposes, because the seller had an incentive to inflate that amount.[27] In *Bryant*, the Tax Court found that the stated purchase price for the beavers did not reflect the taxpayers' true economic cost in the beavers.[28] The Tax Court found that because the taxpayers could use beavers (at the original inflated value) to pay the major portion of their promissory notes, they had no incentive to obtain the lowest possible price.[29] In fact, the taxpayers had an incentive to agree to inflated prices to obtain favorable tax benefits.[30] Because of these peculiar circumstances the Ninth Circuit held that the taxpayers' basis in their beavers was limited to the fair market value.[31]

The Tax Court rejected the taxpayers' argument that they had an incentive to obtain the best possible price for the beavers because they were personally obligated on their promissory notes.[32] The debt could be repaid in beavers and there was little chance that the taxpayers would not be able to repay the debt in beavers because if the beavers died during the first year they would be replaced.[33] The Ninth Circuit agreed with the Tax Court's finding that the taxpayers were not personally at risk on the debt.[34]

For some unexplained reason, Bryant continued to pay in

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26. *Bryant*, 790 F.2d at 1465 (citing *Lemmen v. Comm'r*), 77 T.C. 1326, 1327 (1981)). In *Lemmen*, a taxpayer purchased two herds of cattle. The seller agreed to maintain and care for the cattle in exchange for some of the calves produced during the term of the contract. Lemmen, 77 T.C. at 1327. Because the cattle were depreciable and service contracts are not, the Tax Court determined that the taxpayer had incentive to inflate the price of the cattle. *Id.* After stating the general rule that basis equals cost, the Tax Court held that this rule does not apply where the transaction is not conducted at arms-length or where a transaction is based on peculiar circumstances which influenced the purchaser to agree to a price in excess of the property's fair market value. *Id.* In such cases, the basis of property for tax purposes may be limited to fair market value. *Id.*

27. *Bryant*, 790 F.2d at 1465 (citing *Lemmen v. Comm'r*, 77 T.C. 1326, 27 (1981).

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

cash even after he could have paid with beavers.[35] However, the Ninth Circuit found that Bryant's purchase should be viewed at the time he entered into the transaction and therefore he should be treated the same as the other taxpayers.[36] At the time of the purchase, Bryant agreed to an inflated purchase price, knew of the repayment option in beavers, and was aware of the tax advantages that would be obtained from the transaction.[37] That Bryant did not exercise his option to repay in beavers did not affect the character of this transaction.[38]

The Ninth Circuit next reviewed the Tax Court's determination of fair market value for the beavers. The Tax Court relied on the contemporaneous wholesale purchases by the sellers in these contracts.[39] They were purchasing beavers for $16 to $250 each.[40] Using these prices and by viewing the entire record, the Tax Court determined the fair market value to be $200 per proven beaver, $137 per nonproven beaver, and $29 per yearling.[41]

The Ninth Circuit affirmed the determination of fair market value.[42] It agreed with the Tax Court's finding that the taxpayers' expert estimates were unreliable because they did not take into account the contemporaneous sales of beavers at substantially lower prices.[43] The Ninth Circuit stated that contemporaneous sales are highly probative of value.[44] The majority of these contemporaneous sales were arm's length transactions, not distress sales, and thus were a good indication of value.[45]

Limiting the taxpayers' basis to the fair market value of the beavers resulted in some of the taxpayers having paid principal

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35. *Id.*

36. *Id.* at 1467.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* For a comparison of the stated contract prices, *see supra* note 8 and accompanying text.

42. *Id.*

43. *Id.*

44. *Id.* (citing Estate of Franklin v. Comm'r, 544 F.2d 1045, 1048 n. 4 (9th Cir. 1976); Narver v. Comm'r, 75 T.C. 53, 96-97 (1980), aff'd, 670 F.2d 855 (9th Cir. 1982)).

45. *Bryant*, 790 F.2d at 1467.

amounts in cash for which they would receive no tax benefits.[46] The Tax Court found that this result reflected the economic realities of these transactions.[47] The Ninth Circuit agreed, concluding that it was reasonable that a part of the purchase price for the investment was originally paid for the assumed tax benefits.[48]

Finally, the Ninth Circuit affirmed the Tax Court's holding that the Commissioner sustained his burden of proof that taxpayers Hartman, Webber, and Wohl negligently failed to report investment tax credit recapture.[49] A mere showing that the tax was not paid is not enough to prove negligence for this purpose, but, the Commissioner also showed that the taxpayers were sophisticated businessmen who were aware of the recapture provisions.[50] The Ninth Circuit rejected Hartman's argument that failure to report investment tax credit recapture was not negligent because he received a replacement beaver for each that died.[51] The Ninth Circuit found that Hartman's statement constituted an admission.[52]

IV. CONCLUSION

In *Bryant v. Commissioner*, the Internal Revenue Service looked beyond the form or actual language used in a transaction, to its substance or true economic reality. The use of specific terms or prices in a contract will not always be determinative in computing tax liability. Where express terms do not reflect the true economic cost of an investment, the Internal Revenue Service will disregard such terms and analyze the realities of the transaction.

*William K. Peterson**

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46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 1467-68 (citing 26 U.S.C. § 6653(a) (1982) which imposes an addition to tax for any underpayment of tax which is the result of negligence or intentional disregard of the rules or regulations).

50. *Bryant*, 790 F.2d at 1468-69 (citing Poen v. Comm'r, 48 T.C.M. 867, 868 (P-H 1979)).

51. *Id.*

52. *Id.*

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