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Taxation

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TAXATION

I. EMPLOYMENT-RELATED EXPENDITURES MAY LEAD TO DEDUCTIONS OR EXCLUSIONS IN THE NINTH CIRCUIT

Recently, in Coombs v. Commissioner\(^1\) and Folkman v. United States,\(^2\) the Ninth Circuit ruled on the deductibility of travel expenditures pursuant to I.R.C. section 162(a)(2)\(^3\) in the context of the location of a taxpayer's "tax home." In another case, Sibla v. Commissioner,\(^4\) the court determined whether a taxpayer's payments into a mandatory meal plan at his place of employment could be deducted from income pursuant to I.R.C. section 162(a),\(^5\) or excluded from income under I.R.C. section 119.\(^6\)

1. 608 F.2d 1269 (9th Cir. 1979) (per Wallace, J.; the other panel members were Trask, J., and Zirpoli, D.J., sitting by designation).
2. 615 F.2d 493 (9th Cir. 1980) (per Goodwin, J.; the other panel members were Browning, J., and Bartels, D.J., sitting by designation).
3. I.R.C. § 162 provides in pertinent part:
   
   (a) in general.—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, including—

   (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business . . . .

4. Sibla v. Commissioner, 611 F.2d 1260 (9th Cir. 1980) (per Curtis, D.J., sitting by designation; Kennedy J., dissenting; the other panel member was Tang, J.).
5. See note 3 supra.
6. I.R.C. § 119 provides in pertinent part:
   
   (a) There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any other of his dependents by or on behalf of his employer for the convenience of the employer, but only if—

   (1) in the case of meals, the meals are furnished on the business premises of the employer . . . .

   (b)(3) Certain fixed charges for meals.—
   
   (A) In general. —If—

   (i) an employee is required to pay on a periodic basis a

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A. Coombs v. Commissioner

Background

All taxpayers\(^7\) in Coombs were employees at the Nevada Test Site,\(^8\) a nuclear testing facility operated by the United States government. Most of the taxpayers lived sixty-five miles away in Las Vegas, Nevada, the closest habitable community to the Test Site.\(^9\) Cox v. United States,\(^10\) the companion case to Coombs, was based upon a similar factual situation.

Other than military personnel, there were 100 federal employees and 4,000 employees of private contractors who worked at the Test Site.\(^11\) All employees received a per-diem Test Site allowance,\(^12\) which was paid without regard to the actual costs

\[
\text{fixed charge for his meals, and} \]

\[(ii) \text{such meals are furnished by the employer for the convenience of the employer, there shall be excluded from the employee's gross income an amount equal to such fixed charge.} \]

(B) Application of subparagraph (A). Subparagraph (A) shall apply—

\[(i) \text{whether the employee pays the fixed charge out of his stated compensation or out of his own funds, and} \]

\[(ii) \text{only if the employee is required to make the payment whether he accepts or declines the meals.} \]

7. Unless a spouse of a taxpayer filing a joint return, all taxpayers were employed at the Nevada Test Site. 608 F.2d at 1271.

8. Each of the taxpayers in question was an employee at the Nevada Test Site for at least some time from 1970 through 1973. Although the government carried out other activities at the Test Site, its primary use was as a nuclear testing facility. Because of the dangers of such a facility, the government chose the Nevada desert location because it was removed from populated areas. Id.

9. The primary entrance into the Test Site was the Camp Mercury Control Point, located on its southernmost boundary. In order to reach the northernmost boundary, a person must travel an additional 65 miles. The Test Site encompasses some 1,350 square miles of remote Nevada desert. Aside from the primary entrance, there are two additional entrances, which are seldom used and therefore are of little importance to this Note. See Coombs v. Commissioner, 67 T.C. 426, 432 (1976).

10. 608 F.2d 1269 (9th Cir. 1979).

11. The taxpayers involved in this appeal were employees of private contractors or construction workers who were members of craft unions. The craft union employees were unable to avail themselves of a free bus service for transportation between the Camp Mercury Control Point and their forward work stations on the Test Site, and also between work sites. However, they received an additional travel allowance. 608 F.2d at 1272.

12. Id. This Test Site allowance was additional to the taxpayers' regular wages and was paid for each day that they reported to their work stations at the Test Site. The amount paid varied depending upon the taxpayers' work station; those reporting to Camp Mercury received $5.00 per day, while those reporting to any forward area re-
incurred for transportation, meals, and lodging.\textsuperscript{18}

At times, the taxpayers’ employers required them to perform overtime work at the Test Site. Due to the great distance between their homes and the Site, some of the taxpayers who worked overtime purchased meals at the Site. Additionally, some rented lodging on the Site when they chose not to return home after overtime work.\textsuperscript{14} However, the Cox taxpayers kept no records for these expenditures.

Both the district court in Cox, and the Tax Court in Coombs, determined that the Test Site allowances were not excludable from income under section 119.\textsuperscript{15} Both courts also disallowed the taxpayers’ claim to a deduction for travel expenses incurred on commute between their residence and the Test Site entrance, and those incurred between the Site entrance and their forward work stations. The courts held that these were personal commuting expenses incurred in travel between the taxpayers’ home and their place of employment, and were not deductible as ordinary and necessary business expenses.\textsuperscript{16} In addition, both courts held that the taxpayers’ “tax homes” were on the Test Site, which precluded the taxpayers from meeting the Correll “away from home overnight” test.\textsuperscript{17} This finding, in addition to what they found to be a lack of business purpose, led the courts to disallow the taxpayers’ claim to a deduction under section 162 for meal and temporary lodging expenses incurred at the Test Site.\textsuperscript{18} The courts disallowed the claim regardless of

\begin{itemize}
\item received $7.50 per day. Employees who were members of particular craft unions received an additional travel allowance which varied in accordance with the location of their work stations. \textit{Id.} at 1271.
\item During the years in question, The Atomic Energy Commission also provided subsidized transportation from Las Vegas to the Camp Mercury Control Point, and points within the Test Site. However, the bus transportation was provided only to employees of the private contractors and the federal government. Construction workers who were members of craft unions were not permitted to use the bus service. Coombs v. Commissioner, 67 T.C. at 433-34.
\item Taxpayers were able to rent sleeping quarters for overnight stay at rates varying in amount between $1.00 and $2.00 per night. Cox v. United States, [78-2] U.S. Tax Cas. (CCH) ¶ 9572 at 84,834 (D. Nev. 1978).
\item \textit{Id.} at 84,835; Coombs v. Commissioner, 67 T.C. at 427.
\item [78-2] U.S. Tax Cas. at 84,835-37; 67 T.C. at 473-80.
\item \textit{Id.} \textit{See} note 118 \textit{infra}.
\item The courts based their holdings primarily on the fact that the taxpayers were not required by their employers to stay overnight, and therefore the decision to stay overnight was personal and not related to business. [78-2] U.S. Tax Cas. at 84,836-37; 67
\end{itemize}
whether the taxpayers worked overtime, or whether they slept overnight at the Test Site when they incurred these expenses.

One Job: Tax Home At Personal Residence

After initially recognizing the taxpayers' abandonment of any claim to an exclusion from income under section 119, the Ninth Circuit addressed the Cox taxpayers' contention that overtime related expenses were deductible from income pursuant to the general provisions of section 162(a). Based upon the Tax Court's decision in Sibla v. Commissioner,20 and Cooper v. Commissioner,21 the taxpayers attempted to avoid the impact of the rule that the mere requirement by an employer that an employee work overtime will not justify the employees' deduction of meal expenses incurred at their place of work after the completion of their regular shift.22 The court stated that even if they affirmed Sibla and Cooper, those decisions provided for deductions only where the employer requires the employees to pay for and receive meals from a particular source as a condition of employment.23 Simply that the taxpayers were required to work overtime was not sufficient reason to deduct expenses for meals and lodging pursuant to section 162(a).24

Additionally, Cox taxpayers argued that their overtime-related expenses were deductible under section 162(a)(2) as travel

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19. 608 F.2d at 1272. The taxpayers' abandonment of their claim to an exclusion under § 119 was based upon Commissioner v. Kowalski, 434 U.S. 77 (1977). Kowalski had been decided subsequent to the district court's ruling in Coombs, but prior to the Tax Court's decision in Cox. The Kowalski Court stated that "the form of section 119 which Congress enacted originated in the Senate and the report accompanying the Senate Bill is very clear: 'Section 119 applies only to meals or lodging furnished in kind.' S. Rep. No. 1622, 83rd Cong. 2d Sess., 190 (1954)." Id. at 84. See also, Treas. Reg. § 1.119-1(c)(2) (1964), 26 C.F.R. § 1.119-1 (1977). In Kowalski, New Jersey State Troopers were given a cash meal allowance, which was included in their salary checks, to spend on meals during their meal breaks. Because the taxpayers' Test Site allowances were in cash and not in kind, the Ninth Circuit held that they "have properly abandoned any claim to exclusion . . . ." 608 F.2d at 1272.


23. 608 F.2d at 1273. The Cox taxpayers did not allege that they were required to purchase overtime related meals or lodging at the Test Site as a condition of their employment.

24. Id.
expenses. In order to address this claim, the court looked to Commissioner v. Flowers, where the Supreme Court established criteria for the deductibility of travel expenses. The expense must be a reasonable and necessary travel expense incurred "while away from home," in the pursuit of the taxpayer's trade or business. The court added the additional qualification based upon United States v. Correll, that all travel expenses on trips that require neither sleep nor rest are not deductible pursuant to section 162(a)(2). Pursuant to the "sleep or rest" rule, the taxpayers' overtime-related expenses for meals were not justifiably deductible simply because they were required to work overtime.

The more pressing question for the court, however, was the taxpayers' contention that when they slept overnight at the Test Site due to the exigencies of their employers' business, they were "away from home" pursuant to section 162(a)(2), and therefore entitled to deduct related expenses. As a corollary to this argument, the taxpayers maintained that their "tax homes" were their individual residences, or, in the alternative, their individual work stations at the Test Site, but not the entire Test Site.

Reversing the conclusions of the Tax Court and district court, which held that the taxpayers' "tax homes" included the entire Test Site, the Ninth Circuit concluded that the location of one's "tax home" is a question of fact for the purposes of section 162(a)(2). In this regard, regularly employed taxpayers have as a "tax home" their abode at their principal place of bus-

25. Supra note 3.
28. 608 F.2d at 1274. The court also stated that it was irrelevant that the expenses were incurred while traveling, unless the "sleep or rest" rule of United States v. Correll, 389 U.S. 299 (1967) was met.
29. Id.
30. Id.
31. Id.
32. Id. The court cited Frank v. United States, 557 F.2d 93, 97 (9th Cir. 1978), which in turn cited Curtis v. Commissioner, 449 F.2d 225, 227 (5th Cir. 1971), for the proposition that except for a taxpayer who has only one abode, the location of that taxpayer's "tax home" is a question of fact. While on first impression there appeared to be confusion in the Ninth Circuit as to the location of a taxpayer's "tax home," the court stated that there never was any such confusion.
ness or employment. Although it had previously held that a taxpayer's principal place of business is his or her "home" for tax purposes, the court did not mean it to be the address of the taxpayer's business or that of his or her employer. Therefore, the court stated that it had never held the actual address of a taxpayer's place of employment to be his or her tax home.

Pursuant to the rules announced in Commissioner v. Stidger, Smith v. Warren, and Sanders v. Commissioner, the Commissioner and the Government claimed that the Ninth Circuit should find that a "tax home" and place of business are synonymous. The court distinguished the cited cases on their facts and refused to make such an extension. It found support in Barnhill v. Commissioner, where that court stated that although the statute implies taxpayers' "homes" must be in the same general locale as their place of employment, it does not mean that the word "home" should be synonymous with the term "place of business."

33. 608 F.2d at 1274.
34. Id. at 1275. The court referred to its decision in Wills v. Commissioner, 411 F.2d 537, 539 (9th Cir. 1969). It stated that in Wills, the professional baseball player's home for tax purposes was Los Angeles, and not the Dodger ballpark. The court held that this reasoning is "wholly consistent with our decision in Wright v. Hartsell, [305 F.2d 221, 225 (9th Cir. 1962)], where, although in a different situation, we stated that a taxpayer may be expected to mitigate his expenses by living as near to his job site as is reasonably possible." 608 F.2d 1275. Although United States v. Correll, 389 U.S. 299 (1967), and Sanders v. Commissioner, 439 F.2d 296, 299 (9th Cir.), cert. denied, 404 U.S. 864 (1971), changed the law in this area, the court stated that "neither case modified our implicit reaffirmation that a taxpayer's 'home' is his abode." 608 F.2d at 1274.
35. 608 F.2d at 1275.
36. 386 U.S. 287 (1967). The Stidger Court held that "insofar as military personnel are concerned, their permanent duty stations are also their homes for the purposes of determining the deductibility of travel expenses. The court explicitly refrained from adopting any rule applicable to taxpayers generally." 608 F.2d at 1275 (citations omitted).
37. 388 F.2d 671, 673 (9th Cir. 1968) (per curiam). The court stated at 1275, that in Smith it considered the deductibility of travel expenses pursuant to the general provisions of section 162(a), and the section 162(a)(2) travel expense provision was not at issue.
38. 439 F.2d 296 (9th Cir.), cert. denied, 404 U.S. 864 (1971). The Sanders court concluded that any travel expense deduction under § 162(a)(2) was precluded by the "sleep or rest" rule of United States v. Correll, 389 U.S. 299 (1967).
39. 608 F.2d at 1275.
40. 148 F.2d 913, 917 (4th Cir. 1945).
41. 608 F.2d at 1275. The court also stated that where a taxpayer accepts employment for an indefinite period of time away from his usual abode, that taxpayer's "tax home" will shift to the new place of employment, because a decision to maintain the former abode is one of personal choice and therefore the expenses are nondeductible.
The specific circumstances of the taxpayers in the instant case led the Ninth Circuit to find that the Tax Court and the district court were in error when they found that the taxpayers' "tax homes" were not their personal residences. Such error was found because the taxpayers maintained their homes in Las Vegas, the closest habitable community to the Test Site. 42

Having determined the taxpayers' "tax homes" were their personal residences in Las Vegas, the court accepted the taxpayers' claim that when they slept overnight at the Test Site, due to the exigencies of their employers' business, they were "away from home" within the meaning of section 162(a)(2). 43 This conclusion was based upon the unique circumstances of the taxpayers. Because the taxpayers encountered an unavoidable distance between their homes and jobs, when they found it necessary to sleep overnight at the Test Site due to the requirement that they perform overtime work, they were entitled to deduct the costs of extra meals and lodging incurred under section 162(a)(2). 44

However, because the Cox taxpayers failed to properly substantiate their expenses, the Ninth Circuit denied their claimed deductions. The Coombs cases were remanded for further proceedings consistent with the court's opinion. 45

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42. 608 F.2d at 1276. However, pursuant to Sanders, the taxpayers were unable to deduct their daily commuting expenses incurred between their homes and the Test Site as travel expenses.

43. 608 F.2d at 1276. The court attempted to balance the equities between the taxpayers in the instant case and the average daily commuter, and in addition, to consider the policy of § 162(a)(2) to take into account the extraordinary, often duplicative costs, especially for lodging, that a taxpayer incurs in travel away from home in the pursuit of business. The court cited United States v. Correll, 389 U.S. at 303-05; Brandl v. Commissioner, 513 F.2d 697, 699 (6th Cir. 1975); Rosenspan v. United States, 438 F.2d 905, 912 (2d Cir.), cert. denied, 404 U.S. 864 (1971); Commissioner v. Bagley, 374 F.2d 204, 206 (1st Cir. 1967); and James v. United States, 308 F.2d 204, 206-07 (9th Cir. 1962).

44. 608 F.2d at 1276-77.

45. Id. at 1277-79. The district court determined that the Cox taxpayers failed to substantiate their expenses pursuant to § 274(d). The Cox taxpayers claimed that the district court erred when it failed to exempt them from the substantiation requirement of § 274(d) pursuant to Rev. Rul. 71-412, 1971-2 C.B. 170. The Ninth Circuit held that the taxpayers received their allowances whether or not they were required to expend such allowances for meals or lodging in the pursuit of their employers' business, and thus, they failed to meet the requirements of Rev. Rul. 71-412, and Treas. Reg. § 1.274-5(f) (T.D. 7226, Dec. 15, 1972, 37 F.R. 26711). In its denial of a travel expense deduction
B. Folkman v. United States

Background

Folkman had as its companion case, Dehne v. United States, which was based upon similar circumstances. Both taxpayers were airline pilots employed by Pan American World Airways and stationed in San Francisco, California. In order to maintain their proficiency as pilots, they enlisted in the Nevada Air National Guard Air Reserve Unit (the Guard) stationed in Reno. As a condition of their employment, the Guard required that all pilots live in Reno. Therefore, both taxpayers moved their families to Reno and commuted to their Pan American duty posts.

During the applicable tax years, both taxpayers worked more days for Pan American, and derived considerably more income from Pan American than from the Guard. The taxpayers to the Cox taxpayers, the Ninth Circuit affirmed the district court’s finding on the basis of the taxpayers’ failure to properly substantiate their expenses.

The taxpayers in Cox and Coombs who were members of craft unions claimed that because they were unable to make use of the free bus service while on the Test Site, they were entitled to deduct their daily on-site transportation costs incurred between the Camp Mercury Control Point and their forward work stations. The Ninth Circuit recognized that under Steinhort v. Commissioner, 335 F.2d 496, 504 (5th Cir. 1964), travel expenses incurred by a taxpayer who must travel from one work site to another are generally deductible. However, because the district court and the Tax Court concluded that the Camp Mercury Control Point was an arbitrary middle point on the taxpayers’ daily commute to work, the only issue that the Ninth Circuit recognized in this regard was whether Camp Mercury was such a middle point, or whether it could be considered the taxpayers’ office. The court agreed with the courts of the first instance in both cases that the present facts were analogous to those in White v. Commissioner, 31 T.C.M. 273 (1972), where, although the taxpayer had a substantial distance to commute, fifteen miles of which was on his work site after entering the main gate, the court concluded that he was not entitled to a deduction for the cost of travel on site. The Ninth Circuit could not find that the lower courts’ findings were clearly erroneous and affirmed the denial of deductions to the craft union taxpayers for on-site travel expenses.

Finally, the Ninth Circuit rejected the taxpayers’ contention that the Commissioner discriminated against them when his Baltimore District Director issued a private “letter ruling” to the federal employees on the Test Site. The ruling simply set forth general rules for withholding taxes on per diem allowances, including such allowances in income, and therefore the lower courts did not err in rejecting the discrimination claims.

46. 615 F.2d 493 (9th Cir. 1980).
47. Id. at 494. Although both taxpayers were initially stationed in San Francisco, Dehne was transferred to Kennedy Airport in New York City. During the relevant tax years, Dehne traveled between his Pan American duty post at Kennedy Airport, and his family residence in Reno.
48. Id. at 494.
claimed deductions for the cost of travel between Reno and their airline duty posts. All the deductions were disallowed, and the Commissioner assessed additional taxes for the resultant deficiencies.

Deciding both cases together, the district court found that the taxpayers' "tax homes" were in Reno and not at their Pan American duty posts as the Government had contended. Based upon this finding, the district court found that the costs incurred by the taxpayers in travel between Reno and their respective airline duty posts were travel expenses incurred while "away from home" and deductible pursuant to section 162(a)(2). The court also allowed as a deduction the cost of meals and lodging incurred by the taxpayers at their respective airline duty posts.

Two Jobs: Tax Home at "Abode" at Principal Duty Post

Unlike in Coombs, the Folkman court focused only on section 162(a)(2) travel expense deductions. In reversing the district court which had held that the taxpayers' "tax homes" were in Reno and not at their airline duty posts, the court referred to its earlier decision in Coombs. Based upon the Coombs holding that a "tax home" is a personal residence at the principal place of employment, the court had to determine which of the taxpayers' two places of employment was their "principal place of employment."

In an effort to resolve what it believed to be a difficult question, the court adopted the objective three-part definitional approach proposed by the Government and adopted by the Sixth

49. The applicable tax years were 1971 and 1972.
50. Folkman also claimed deductions for the cost of meals when he served with the Guard. Dehne claimed deductions for food and lodging expenses incurred at his Pan American duty post in New York.
52. Id.
53. Id. at 1030.
55. 608 F.2d at 1275.
56. Rev. Rul. 54-147, 1954-1 C.B. 51, 52. In an announcement on § 162(a)(2)'s predecessor, I.R.C. of 1939, ch. 1, § 23(a)(1)(A), 53 Stat. ch. 2, the Government stated factors to be considered in cases where "baseball players, managers, coaches, or trainers also engage in another trade or business during the taxable year."

The more important factors to be considered in making a fac-
Circuit in *Markey v. Commissioner.* The test, as adopted by the court in *Folkman,* provides the following factors for consideration to determine the principal place of employment: (1) the length of time the taxpayer spent in each location; (2) the taxpayer's degree of business activity at each location; and (3) the financial return to the taxpayer with respect to each location.

After applying this test to the taxpayers in *Folkman,* the court determined that their principal places of business were their respective airline duty posts. Although the taxpayers spent most of their time in Reno, where they maintained their family residences, they derived significantly more of their income from their Pan American jobs. They also devoted the vast majority of their working time to their airline jobs. Because the taxpayers' principal place of employment was at their airline duty posts, their "homes" for tax purposes were their personal residences at their respective duty posts.

For the remainder of its opinion, the court focused upon the "away from home" aspect of section 162(a)(2). The Ninth Circuit determined that even though the taxpayers maintained family residences in Reno, they did so for business reasons.
Even though the Guard had imposed a residency requirement on all pilots, the court held that the travel expenses incurred when the taxpayers served with the Guard would have been deductible anyway. Because the taxpayers' family residences were located in Reno for sound business reasons and not because of personal fancy, the taxpayers were allowed to deduct the related travel expenditures that were ordinarily and necessarily incurred in the pursuit of business.

The Ninth Circuit vacated the judgments of the district court and remanded the cases for entry of modified judgments. The modified judgments were to be based upon a determination by the district court of the number of trips the taxpayers made to Reno that included guard duty.

C. *Sibla v. Commissioner*

*Background*

Both taxpayers, Sibla and Cooper, were employed by the Los Angeles Fire Department (LAFD) for the taxable years in question. The taxpayers normally worked twenty-four hour shifts and were not permitted to leave the fire station on per-

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64. Id. Under Rev. Rul. 54-147, supra note 56, “taxpayers may deduct [their] travel expenses incurred in discharging their duties at the city which is removed from the principal place of business.” Note, however, the Folkman panel considered the taxpayers’ residency requirement as analogous to a valid business purpose. Cf. Dean v. Commissioner, 35 T.C.M. 1706 (1976) (absence of a residency requirement supported a personal motive for taxpayer’s change of residence).

65. 615 F.2d at 497.

66. Id. at 498.

67. Id.

68. Richard R. Sibla filed a joint federal income tax return with his wife for the calendar year 1973, and he appeared pro se in the Tax Court and in the Ninth Circuit. In another action, Sibla appealed his conviction on two counts of willful failure to file an income tax return, in violation of I.R.C. § 7203. The sole issue on appeal was whether the district judge committed reversible error in denying Sibla’s motion for recusal of the judge. Sibla contended that because the judge admonished him during a discovery motion at a pretrial hearing where he made a “frivolous legal argument concerning the validity of the federal tax scheme,” demonstrated prejudice. Sibla’s motion and accompanying affidavit pursuant to 28 U.S.C. § 144 (1976), that the judge recused himself was denied in the district court on the ground that the affidavit was insufficient on its face because it did not state sufficient grounds for recusal. On appeal, the Ninth Circuit found no reversible error and affirmed the decision of the district court. United States v. Sibla, No. 78-1724 (9th Cir. March 3, 1980).

69. Robert E. Cooper filed an individual federal income tax return for 1972 and 1973, the taxable years in issue.
sonal business while on duty. Unless officially excused by the Fire Commissioner, all firefighters were required to participate in a "nonexclusionary organized mess" at the station house.

LAFD provided the kitchen facilities. The firemen, however, generally organized the activities, provided the utensils, purchased and prepared the food, and collected the money. All employees were required to pay the mess fee even though they might be away from the station house on LAFD business during the mess period.

In 1973, Sibla deducted his total payments into the plan for the year. Cooper deducted his payments for both 1972 and 1973. Both taxpayers claimed the deductions as "ordinary and necessary business expenses" pursuant to section 162(a). The Commissioner disallowed the expenses as nondeductible personal expenses.

Both courts of the first instance found that the taxpayers' mess expenses qualified as "ordinary and necessary business expenses," and held they were deductible under section 162(a). A concurring opinion in the Tax Court in Cooper would have allowed an exclusion of the amount paid into the mess plan under section 119, and disallowed it as a deduction from income pursuant to section 162(a).

70. The only recognized ground for excusal was a physical ailment verified by the city's own examining physician.
71. The meals averaged $3.00 per person, per 24 hour shift.
72. Other issues that concerned Sibla and his 1973 federal income tax return were decided by the Tax Court and are not relevant to this Note: (1) in computing his income subject to tax, Sibla was unable to exclude or deduct amounts withheld from his salary during 1973, as contributions into the LAFD pension fund, 68 T.C. at 427-30; (2) Sibla was not "entitled to any adjustment in gross income he received because of any decline in the value of the dollar with respect to gold or silver," Id. at 431; (3) Sibla was not entitled to a dependency exemption for a 21-year-old son who did not receive over half of his support from him, 68 T.C. at 431; and (4) Sibla was entitled to deduct "ordinary and necessary" expenses of his rental business, 68 T.C. at 432-33.
74. 67 T.C. 870, 874-76 (Simpson, J., concurring). Judge Simpson, in a concurring opinion subscribed to by Dawson, Scott, Tannenwald, Featherson, and Wilbur, J.J., agreed with the conclusion of the majority, in that the taxpayers should not be taxed upon the amounts paid into the mess plan. These judges, however, felt that § 119, provided a stronger basis to avoid tax liability on the part of the taxpayer. Believing that the cost of meals are personal expenditures under § 262, wherein no deduction is allowed for such expenditures unless expressly provided for by statute, the concurring judges
Restrictive Employment Condition Leads To Deduction And Exclusion

The Ninth Circuit initially addressed the taxpayers' claim to a business expense deduction of the "mess fee" under section 162(a). Section 162(a) provides for a "deduction [of] all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." The court compared section 162 to section 262, which disallows deductions for personal expenses not otherwise provided for by statute.

Following the stance of Judge Fay's majority opinion in the Tax Court, the Ninth Circuit reiterated that personal expenses can, when required under certain circumstances by company regulations, lose their personal character and become more akin to business expenses. The court recognized the unusual nature of the taxpayers' employment, the involuntary nature of their mess expenses, and their limited ability to participate in the mess. These factors, combined with their employer's lack of compensatory intent in enacting the mess requirement, provided the basis for the court to affirm the Tax Court's findings that the amounts in issue were business rather than personal expenses.

stated that to allow such a deduction under § 162(a) would create confusion in the courts on the issue of personal expenditures. See note 77 infra for the full text of I.R.C. § 262.
75. 611 F.2d at 1262.
76. I.R.C. § 162(a). For the text of the section, see note 3 supra.
77. 611 F.2d at 1262. I.R.C. § 262 provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."
79. 611 F.2d at 1261. At times, the taxpayers were called away on LAFD business during the mess period, but they were still required to pay for such mess period.
80. 611 F.2d at 1262. In its reluctance to modify the Tax Court's factual findings, the court cited Commissioner v. Heininger, 320 U.S. 467, 475 (1943):
Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. Except where a question of law is unmistakably involved a decision of the Board of Tax Appeals on these issues, having taken into account the presumption supporting the Commissioner's ruling should not be reversed by the federal appellate courts. Careful adherence to
The dissenting judges in the Tax Court stated that the allowance of a deduction for the mess fees under section 162(a) would create confusion, and exacerbate the task of rationally distinguishing between personal and business expenses and therefore, such a deduction should not be allowed under section 162(a). While acknowledging this concern, however, the Ninth Circuit believed that it could not justify an abdication of its difficult duty to determine the Congressional intent of section 162(a).

In an effort to justify its allowance of a business deduction based upon the unique situation of the taxpayers, the court addressed the Commissioner's arguments. On the authority of Steiner v. United States, the Commissioner claimed that mess fee expenses were "personal" rather than "business" in character, and that the taxpayers would have incurred a similar expense for meals whether they ate at work or not. Therefore, they should be nondeductible personal expenses. In distinguishing Steiner on its facts, the court affirmed the Tax Court's finding that the taxpayers' situation was both "unique" and "unusual," and that the amounts in issue were business expenses. To support its analysis, the court cited Pevsner v. Commissioner. In Pevsner the Tax Court allowed a deduction for clothing that a taxpayer was required to wear for her job, even though the clothing was suitable for ordinary wear in certain lifestyles. This principal will result in a more orderly and uniform system of tax deductions in a field necessarily beset by innumerable complexities.

81. 611 F.2d at 1263 (footnotes omitted). Judge Simpson (joined by Dawson, Scott, Tannenwald, Featherson, and Wilbur, J.J.) concurred in the result of the Tax Court, but did so on the ground that the fees should be excludable from income under section 119, and not deductible under § 162(a). See note 74 supra.
82. In his concurring opinion in Cooper, 67 T.C. 870, 876 (1977), Judge Simpson expressed his fear that "[i]f a deduction is allowed under § 612(a) for this personal expenditure, we may be launched down a slippery slope, and it may be difficult to find a rational basis for drawing a line in other cases involving personal expenditures." See note 74 supra.
83. 611 F.2d at 1263.
84. 524 F.2d 640 (10th Cir. 1975). In Stiner, the court refused to allow a deduction for the cost of a uniform where the clothing was suitable for ordinary wear.
85. 611 F.2d at 1262.
86. Id. at 1263.
87. Pevsner v. Commissioner, 38 T.C.M. 1210 (1979). The taxpayer was required to buy and wear high fashion clothes for use in her job, and even though such clothing was suitable for ordinary wear in certain lifestyles, the taxpayer did not pursue such a lifestyle.
lifestyles.

Under the authority of *James v. United States*,\(^8\) and *Laforge v. Commissioner*,\(^9\) the Commissioner also argued that the cost of the taxpayers’ meals was a personal expense and therefore not deductible pursuant to section 162(a). Because both *James* and *Laforge* were so dissimilar from the facts presented in the instant situation, the court held that neither was persuasive.\(^9\) The court also refused to entertain any argument that the taxpayers fell within the purview of two recent Tax Court Memorandum decisions.\(^9\) Neither taxpayer in each of those decisions faced mandatory requirements of their employer as did the taxpayers in this case,\(^9\) and as a result, neither decision was dispositive of the taxpayers’ unique situation.\(^9\)

In its analysis of the taxpayers’ claims to meal exclusions under section 119, the Ninth Circuit pointed to the concurring opinion in *Cooper* in the Tax Court on this issue, and that court’s summary of Treasury Regulation section 1.119-1(a)(3).\(^9\)

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8. 308 F.2d 204 (9th Cir. 1962). *James* involved § 23(a)(1)(A) of the 1939 I.R.C., and concerned a claim based upon the sole issue of the location of a taxpayer’s home.

9. 434 F.2d 370 (2d Cir. 1970). *Laforge* was based upon the substantiation of entertainment expenses and whether the Tax Court correctly computed the portion of country club dues which were deductible as entertainment expenses.

90. 611 F.2d at 1263. See notes 88 & 89 supra.

91. John M. Murphy, 34 T.C.M. 1377 (1975), and Gregory J. Moscini, 36 T.C.M. 1002 (1975). In *Murphy*, the taxpayer, a fireman, was free to eat his own food and was not required to pay into a mandatory mess program. It was unclear whether the court was discussing “deductions” under § 162(a), or the exclusion of the value of the meals furnished for the convenience of the employer under § 119. *Moscini* dealt with a policeman who was not required to purchase meals as a condition of his employment, and the court found no evidence that the taxpayer was ever required to purchase a meal which he did not eat because of his police duties.

92. 611 F.2d at 1263-64. See note 91 supra.

93. Id.

94. 611 F.2d 1264. The Ninth Circuit agreed with the conclusion of the concurring opinion in the Tax Court in *Cooper*. This concurrence was based upon Treas. Reg. § 1.119-1(a)(2) (1964) which provides:

(ii)(a) Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours to have the employee available for emergency call during his meal period. In order to demonstrate that meals are furnished to the employee to have the employee available for emergency call during the meal period, it must be shown that emergencies have actually occurred, or can reasonably be expected to occur, in the employer’s business which have resulted, or will
Under section 1.119-1(a)(3), employees are not taxable on amounts charged for meals if the following conditions are met: (1) The meals are furnished by and for the convenience of the employer; (2) there is a charge for the meals equal to their value; and (3) the charge must be paid whether the employee chooses to eat the meals or not and irrespective of how much he eats.\(^95\)

Even though the employer did not directly purchase the food, supervise the preparation of the meals, or withhold the charge from the taxpayers' compensation, the Ninth Circuit agreed with the concurring judges in the Tax Court,\(^96\) who stated that in substance, the situation in the instant case was indistinguishable from the typical situation where the employer directs the preparation of the meals.\(^97\) The majority in the Tax Court, however, found that the meals were not in fact furnished "in kind" by the employer, and the Ninth Circuit was unwilling to criticize that finding because of the ample evidence to support it.\(^98\) Even so, relying on the record, which was admittedly "sketchy,"\(^99\) the Ninth Circuit stated that a "strong argument

\begin{quote}
result, in the employer calling on the employee to perform his job during his meal period;
\end{quote}

and § 1.119-1(a)(3) (1964), which provides:

(i) If an employer provides meals which an employee may or may not purchase, the meals will not be regarded as furnished for the convenience of the employer. Thus, meals for which a charge is made by the employer will not be regarded as furnished for the convenience of the employer if the employee has a choice of accepting the meals and paying for them or of not paying for them and providing his meals in another manner.

(ii) If an employer furnishes an employee meals for which the employee is charged an unvarying amount (for example, by subtraction from his stated compensation) irrespective of whether he accepts the meals, the amount of such flat charge made by the employer for such meals is not, as such, part of the compensation includable in the gross income of the employee . . . .

\(^95\) 611 F.2d at 1264.
\(^96\) Id. at 1264. The court quoted Judge Simpson's concurrence at 67 T.C. 870, 876 (1977): "There can be no question but that if the meals were furnished in kind, they would qualify for the exclusion." See also note 74 supra.
\(^97\) 611 F.2d at 1265. The majority in the Tax Court found that the expenses in question were "ordinary and necessary" business expenses under § 162(a). 67 T.C. at 870-74 (1977).
\(^98\) 611 F.2d at 1265.
\(^99\) Id. at 1264. The record was "sketchy," in a sense, as to what extent the LAFD actually supervised the preparation of the meals, and the collection of the money. See id.
could have been made that the meals were in fact 'furnished in kind by the employer.' As such, the slim distinction between the Tax Court's findings and this argument was "too slender a reed" upon which the Ninth Circuit would hang tax liability.

The Supreme Court in *Commissioner v. Kowalski*, held that cash meal allowances are not excludable from income under section 119. On this authority, the Commissioner argued that the taxpayers' meal payments are includable in income. In *Kowalski*, the taxpayer was given a cash "meal" allowance over which he had complete dominion. In the instant case, the taxpayers were required to participate in the meal plan at the station house and pay for those meals whether they ate them or not. Because of the distinction between the taxpayers in the instant case and the taxpayer in *Kowalski*, the Ninth Circuit refused to follow the Commissioner's argument, and distinguished *Kowalski* on its facts.

Even though a factual distinction existed, the Ninth Circuit recognized the problem presented by *Kowalski*, in that the Supreme Court would allow deductions for meals “furnished by the employer in kind” but would disallow deductions for “cash advances for food.” Stating that the Supreme Court's concept of “cash allowances” assumes that the taxpayer has complete dominion over his allowance, the court said: "In light of all the circumstances in this case, the meals in question in a very real

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at 1264-65 nn.1 & 2.

100. Id. at 1264. Although the Ninth Circuit believed the evidence was ample to support the Tax Court's findings, it stated that a strong argument could have been made to show that the meals were "furnished in kind by the employer" to illuminate the faint line between the two concepts.

101. Id.


103. The taxpayers in *Kowalski* were New Jersey State Troopers who were given a cash meal allowance that they could spend in any manner they wished. In fact, they were not required to spend it all. The meal allowance was paid whether the taxpayer was on duty, sick leave, or vacation, and regardless of whether he brought his own lunch or ate at home. In addition, the allowance varied with the taxpayer's rank, and the allowance was described in the recruiting brochure as being in addition to the taxpayer's regular salary.

104. 611 F.2d at 1265.

105. Id.

106. Id.

107. The court would not believe the Supreme Court would disallow an otherwise excludable allowance simply because cash was used to implement the employer's plan.
sense were ‘furnished in kind by the employer’ upon the ‘business property’ by means conceived and established by the employer for its convenience.” This being so, the court held the taxpayers should be permitted to exclude from their gross income, pursuant to section 119, the value of these meals even though cash has been used as a simple method to implement the plan. Therefore, the Ninth Circuit held that the taxpayers may choose to either exclude the amounts paid for mess fees under section 119, or deduct them from gross income pursuant to section 162(a).108

Judge Kennedy dissented,109 stating that the taxpayers were entitled neither to a deduction under section 162(a) nor an exclusion pursuant to section 119.110 Because the Tax Court in Cooper, upon which the majority relied, handed down only a plurality decision, he believed that the Ninth Circuit was not bound to give the findings of that tribunal decisive weight. In addition, because Cooper preceded the Supreme Court’s opinion in Kowalski, wherein that Court narrowly interpreted section 119, Judge Kennedy felt that the Tax Court’s decision in Cooper should have been reversed on authority of Kowalski.111 He felt that this could have been done without an overly literal reading of section 119.112

Because the restriction on the taxpayers’ consumption preferences was not great enough to limit their personal taste, Judge Kennedy stated that it is an “occasion for an accession to wealth” over which the taxpayer does not give up “complete dominion.”113 In this regard, he argued that the taxpayers did not give up enough control over their allowances to qualify for the exclusion. Because sections 162 and 119 are legislative exceptions to the generally broad taxing powers of Congress, they should not be judicially broadened beyond their explicit terms.114

108. 611 F.2d at 1265-66.
109. Id. at 1266 (Kennedy, J., dissenting).
110. Id.
111. Id.
112. Id.
113. Id. (citing Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955)).
114. Id. (citing Helvering v. Clifford, 309 U.S. 331, 334 (1940)).
D. ANALYSIS OF THE NINTH CIRCUIT'S REASONING.

In these three cases, the Ninth Circuit dealt with taxpayers whose jobs required certain employment-related expenditures not common to normally employed taxpayers. It seems apparent that under certain restrictive circumstances, the court would be willing to provide taxpayers relief that the tax law in its strictest interpretation would fail to provide. Seemingly, the more restrictive or burdensome the taxpayer's job-related expenditure, the more willing the Ninth Circuit is to mitigate his or her tax liability.

One's Tax Home Is One's Personal Residence or Abode.

The Ninth Circuit has firmly established that one's "tax home" is one's personal residence or abode in, or as near to as is reasonably possible, the locale of one's principal place of employment. This rule reaffirms the Ninth Circuit's traditional position which has historically been at variance with that of the Commissioner and the Tax Court. Since the inception of the Internal Revenue Code of 1939, the Commissioner and the Tax Court have consistently embraced the view that one's "tax home" is one's principal place of business or employment.

The Ninth Circuit affirmed its "tax home" rule in Coombs and Folkman. Taxpayers in Coombs encountered the more burdensome employment-related expenditures. Thus in Coombs, the particular taxpayers' situation may have provided the court an additional impetus to conclude that their "tax homes" were

116. Rev. Rul. 75-432, 1975-2 C.B. 60, 61 provides that it is "the long established position of the Internal Revenue Service that the 'home' referred to in § 162(a)(2) of the code as the place from which traveling expenses must be incurred to be deductible is, as a general rule the place at which the taxpayer conducts the trade or business." This is the basic position also announced in Rev. Rul. 60-189, 1960-1 C.B. 60, 61, and Rev. Rul. 54,497, 1954-2 C.B. 75, 77.
117. In Morgan v. Commissioner, 39 T.C.M. 1263 (1979), the taxpayer's "tax home" was held to be his place of employment even though he maintained a family residence elsewhere. The Tax Court in Bowman v. Commissioner, 39 T.C.M. 381, 385 (1979), stated that "[h]ome for the purposes of section 162(a)(2) means the taxpayer's principal place of business." In Bixler v. Commissioner, 5 B.T.A. 1181, 1184 (1927), the then Board of Tax Appeals made its first ruling on the "tax home" issue, stating that "a taxpayer may not keep his residence at a point where he is not engaged in carrying on a trade or business . . . ."
their personal residences.\textsuperscript{118} \textit{Folkman}, decided shortly thereaf-

\textsuperscript{118} A number of factors may have influenced the court and provided a strong basis for its decision. The policy of § 162(a)(2) "to take account of the extraordinary, often duplicative costs, especially for lodging, incurred while traveling away from home," is a paramount factor. See note 43 \textit{supra}. Under the Commissioner's rule, the taxpayers would not have been away from home when they slept overnight at the Test Site. However, the Ninth Circuit recognized that the taxpayers still had to maintain personal residences while incurring the additional burden of travel expenses related to overtime work. 608 F.2d at 1267-77. In this light, the court's holding that the "tax homes" were the taxpayers' personal residences advanced the policy of § 162(a)(2), while at the same time avoided an inequitable result for the taxpayers.

Although not explicitly stated in its opinion, another factor which may have influenced the court's decision is that both the Commissioner and the Government respectively, took inconsistent positions on the location of the taxpayers' "tax homes." For the purposes of disallowing "away from home" travel expense deductions, both parties maintained the taxpayers' "tax homes" were at the Test Site, but for the purposes of disallowing transportation/commuting expenses, they claimed that the taxpayers' personal residences were in Las Vegas, Nevada. See notes 15 \& 16 \textit{supra} and accompanying text.

Under the Commissioner's and the Government's treatment of the personal residences, the taxpayers were unable to deduct their transportation expenses incurred between their homes and job sites because they were personal commuting expenses. Commuting expenses incurred by an individual between his or her personal residence and normal place of employment are generally considered to be nondeductible personal expenses. Treas. Reg. §§ 1.162-2(e) (1960), 1.212-1(f) (T.D. 7345, Feb. 20, 1975, 40 F.R. 7439), & 1.262-1(b)(5) (T.D. 7207, Oct. 4, 1972, 37 F.R. 20795); Rev. Rul. 75-432, 1975-2 C.B. 59; Feusner v. Commissioner, 413 U.S. 838 (1973); Commissioner v. Flowers, 326 U.S. 465 (1946); Sanders v. Commissioner, 439 F.2d 296 (9th Cir.), \textit{cert. denied}, 404 U.S. 864 (1971).

However, because both parties maintained that the taxpayers' "tax homes" were located on the Test Site, or in the alternative, that they included both the Test Site and the taxpayers' residences, the taxpayers were unable to deduct the related expenses since they were not "away from home" when they stayed overnight at the Test Site according to the test in \textit{Flowers}.

The Ninth Circuit refused to place the taxpayers in such a "no-win" situation. Its definition of "tax home" as the personal residence or abode of the taxpayer prevented the Commissioner and the Government from taking such inconsistent positions in the future through the use of the "tax home" doctrine.

Finally, as the Second Circuit aptly pointed out in \textit{Rosenspan} v. United States, 438 F.2d 905, 910-12 (2d Cir.), \textit{cert. denied}, 404 U.S. 864 (1971), the Commissioner's position that one's "tax home" is at his or her principal place of business, is not necessary to protect the revenue gathering statutes. "That purpose is served, without any such distortion of [the term "tax home"], by the third condition laid down in Flowers, \textit{supra}, 326 U.S. at 470 . . . , namely, 'that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer' and that 'such an expenditure must necessary or appropriate to the development and pursuit of the business or trade.'" 438 F.2d at 911.

In \textit{Rosenspan}, the Second Circuit addressed the issue of whether a traveling salesman has as his "tax home" his employer's principal place of business. It is interesting to note that the Commissioner asserted an exception to its rule, in that a taxpayer who had no home did not have as his or her "tax home" the address of his or her employer's principal place of business. The Second Circuit rejected the Commissioner's argument and held that a taxpayer who had no home could not be "away from home" pursuant to § 162(a)(2).
ter, followed the Coombs "tax home" rule in the context of taxpayers with two places of employment. In Folkman, the taxpayers' employment-related expenditures were not as burdensome as those incurred by the taxpayers in Coombs, and the court's focus was upon the determination of one's principal place of business.

**Historical Analysis of the Ninth Circuit's "Tax Home" Rule**

The Ninth Circuit has often addressed the "tax home" location issue, and has had ample opportunity to hold that one's "tax home" and place of business are synonymous. Although there was some implication, stemming from Smith v. Warren and Wills v. Commissioner, that the court might acquiesce to the Commissioner's "tax home" view, it has never retreated from its traditional rule.

In determining its definition of one's "tax home," the Ninth Circuit was never governed by any precedent in the Supreme Court, which failed to define the term as it appears in section 162(a)(2). When the Ninth Circuit addressed the "tax home"

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Because the purpose of the revenue gathering statutes can be met through use of the third condition of the Flowers test, the Commissioner's general rule that one's "tax home" is one's principal place of business is redundant, and at times, as in Coombs, causes inequitable results without any furtherance of the policy of § 162(a)(2).

119. In Folkman, the taxpayer's principal places of duty were found to be in New York and San Francisco, respectively. 615 F.2d at 496. Because Coombs requires that one's "tax home" be one's personal abode in the locale of their principal place of business, and the taxpayers stayed at hotels when at their principal duty post, 615 F.2d at 495 n.7, the taxpayers' "tax homes" would be their hotel locations. In this regard, the taxpayers did not have to bear the duplicative costs of lodging when they traveled away from their "tax homes."

120. 388 F.2d 671 (9th Cir. 1968). See notes 128, 129 & 132 infra and accompanying text.

121. 411 F.2d 537 (9th Cir. 1969). See notes 130-132 infra and accompanying text.

122. Beginning with Wallace v. Commissioner, 144 F.2d 407 (9th Cir. 1944), the Ninth Circuit has interpreted "tax home" to mean personal residence of abode. In Wallace, the court held that a "home" in relation to a place of abode is the dwelling place of a person. The court in James v. United States, 308 F.2d 204 (9th Cir. 1962), stated that "home" refers to residence and not one's principal place of business. In Wright v. Hartsell, 305 F.2d 221 (9th Cir. 1962), the court found that the taxpayer's inability to live near his job site was a valid ground for a travel expense deduction. In Harvey v. Commissioner, 283 F.2d 491 (9th Cir. 1960), the court held that a taxpayer's "tax home" was his home, despite the fact that the taxpayer was transferred to another location because of his job.

123. Commissioner v. Flowers, 326 U.S. 465, 470 (1946) rev'd 148 F.2d 163 (5th Cir. 1946), provided a three part test which must be met for a travel expense deduction under the applicable predecessor to § 162(a)(2):
issue in *Wright v. Hartsell*, a case factually similar to *Coombs*, it held that the taxpayers' inability to live near his job site was a valid ground for a travel expense deduction. Although *Hartsell* was later modified by *United States v. Correll* and *Sanders v. Commissioner*, its rule on the “tax home” issue remained unaffected.

(1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling;

(2) The expense must be incurred while away from home; and

(3) The expense must be incurred in the pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the taxpayer's trade or business or that of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

The Court refused to define whether the taxpayer's “tax home” was his abode or place of business, because the Court determined that the expenses in issue were not incurred in the pursuit of business. 326 U.S. at 471.

In *Peurifoy v. Commissioner*, 358 U.S. 59 (1958) aff'd 254 F.2d 483 (4th Cir. 1957), the Court found that only temporary employment was at issue where the taxpayers held construction jobs in another city. Therefore, it made no finding on the location of one's “tax home.”

Finally, in *Stidger v. Commissioner*, 386 U.S. 287 (1967) rev'd 355 F.2d 294 (9th Cir. 1965), the Court failed in its third opportunity to define the term “tax home.” Here the Court held that the permanent duty post of a military man in Japan was his “tax home” and not his family home in California. However, the Court expressly declined to extend this rule to taxpayers generally. See *Rosenspan v. United States*, 438 F.2d 905, 910-12 (2d Cir. 1971), cert. denied, 404 U.S. 864 (1971).

124. 305 F.2d 221 (9th Cir. 1962). In *Hartsell*, the taxpayer was faced with a situation where the nearest habitable location was 46 miles from his place of employment. The Ninth Circuit held that “a taxpayer's inability to live near the jobsite [was] a valid ground for deduction as a travel expense of the resulting cost of his transportation, food, and lodging.” *Id.* at 225. The court did not hold that the taxpayer's “tax home” was at his place of employment.


127. United States v. Correll, 389 U.S. 299 (1967), and *Sanders v. Commissioner*, 439 F.2d 246 (9th Cir.), *cert. den.*, 404 U.S. 864 (1974), substantially modified *Hartsell* in terms of the “sleep or rest” rule, and commuting expense deductions, respectively. In fact, *Sanders* has been viewed by commentators as overruling *Hartsell*. [1979] Tax Mgmt (BNA) No. 400 at A-8. However, the *Sanders* Court based its holding upon commuting expenses, and made no determination on the issue of one's “tax home.” Therefore, although the Ninth Circuit had the opportunity to accept the Commissioner's definition of “tax home,” it did not do so.

*See also*, *Harvey v. Commissioner*, 263 F.2d 491 (9th Cir. 1960); *Crowther v. Commissioner*, 269 F.2d 292 (9th Cir. 1960).
In Smith v. Warren, the Ninth Circuit disallowed a ship pilot’s claim to a deduction for transportation expenses incurred in travel between his home, which he claimed was his business office, and his job assignments. This decision implied that the court might acquiesce to the Commissioner’s view. As one commentator suggested, the court’s disallowance of the taxpayer’s claim stood for the proposition that his “tax home” was the entire port area from which he piloted ships. Wills v. Commissioner, decided a year later, could easily have added to the implication of acquiescence. Support for the implication in Wills would be based upon the Ninth Circuit’s holding that a professional baseball player’s “tax home” was in Los Angeles where he was principally employed, even though he maintained his personal residence in Spokane, Washington.

However, although one could glean an inference of acquiescence from Smith and Wills, the cases, if examined closely, do not deviate from the Ninth Circuit’s traditional position. In Smith, the court’s disallowance of the taxpayer’s claim was based upon section 162(a) business expense deductions and not section 162(a)(2) travel expenses. Therefore, no decision on the location of the taxpayer’s “tax home” was made. In Wills, the Ninth Circuit held the taxpayer’s “tax home” was in Los Angeles and not at Dodger Stadium, his principal place of employment. In this vein, Wills’ “tax home” would be his personal abode in Los Angeles.

In continuing with its traditional position, the court held more recently in Frank v. United States, that the location of one’s “tax home” is a question of fact. The court did not apply the rule advanced by the Commissioner that one’s “tax home” is one’s principal place of business or employment.

If any question remained after the Frank decision that the Ninth Circuit’s “tax home” doctrine was in a state of conflict, Coombs reaffirmed the traditional position. In Coombs, the court

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128. 388 F.2d 671 (9th Cir. 1968).
130. 411 F.2d 537 (9th Cir. 1969).
131. 388 F.2d at 672.
132. 411 F.2d at 540.
133. 577 F.2d 93, 97 (9th Cir. 1978).
specifically held "when a regularly employed taxpayer maintains his personal residence or abode within the general area of his employment or as close thereto as is reasonably possible . . . his "tax home" is that personal residence or abode."134

It should be noted, however, that Coombs requires a taxpayer to live in, or as close as is reasonably possible, to his or her place of employment in order to mitigate the travel expenses incurred.135 The fact that the Coombs taxpayers’ "tax homes" were held to be in Reno, sixty-five miles away from the general locale of their jobs, appears to be based upon the restrictive nature of their jobs and their inability to live nearer their job sites.136 In the absence of employment-related restrictions such as in Coombs, a normally employed taxpayer’s decision to live outside the general area of his or her employment should be considered to be one of personal choice.137 Coupled with the mitigation requirement of Coombs, the taxpayer’s “tax home” should still be considered to be in the general locale of his or her principal place of employment, even though the taxpayer maintains no “abode” in such location.

Folkman, the Ninth Circuit’s most recent decision on the “tax home” issue, buttressed the Coombs rule that one’s “tax home” is one’s personal residence or abode. However, prior to the court’s application of its “tax home” rule in Folkman138 it

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134. 608 F.2d at 1275.
135. Id.
136. See note 118 supra.
137. Pursuant to § 262, personal expenditures are nondeductible unless provided for specifically by statute. In Coombs, the Ninth Circuit recognized this provision of § 262 at 608 F.2d at 1276. See note 77 supra for the full text of I.R.C. § 262.
138. Although the Folkman court set out the Coombs “tax home” rule prior to its determination of the taxpayer's principal place of business, 615 F.2d at 495, in order to actually apply the rule it first had to determine the principal place of business.

Because the Ninth Circuit and the district court found that the taxpayers’ “tax homes” were at their principal place of employment and not at their personal residences, the Ninth Circuit was forced to readdress the deductibility of travel expenses in this new context. See 433 F. Supp. 1022, 1029 (D. Nev. 1977); 615 F.2d at 496. In this regard, the Government contended that the taxpayers' travel expenses incurred between their “tax homes” and their personal residences in Reno were nondeductible personal expenses. Note 77 supra.

The underlying premise of this argument is that the taxpayers traveled to Reno primarily to visit their families and not to pursue their employment with the Guard. Had this argument any merit, the Ninth Circuit's allowance of a deduction for travel expenses would have been erroneous, even though the taxpayers actually performed Guard duty for the times they claimed deductions. Treas. Reg. § 1.162-2(b)(1) (1960) provides:
had to determine which of two possible places was the taxpay-

If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is personal in nature, the traveling expenses are not deductible even though the taxpayer engages in business activities while at such destination. (Emphasis added.)

See Matteson v. Commissioner, 514 F.2d 43 (8th Cir. 1975); Mazzotta v. Commissioner, 57 T.C. 427 (1971), aff'd per curiam, 465 F.2d 1399 (2d Cir. 1972); Green v. Commissioner, 35 T.C. 764 (1961), aff'd, 298 F.2d 890 (6th Cir. 1962); Alexander v. Commissioner, 39 T.C.M. 410 (1979). These cases stand for the proposition that if a taxpayer is unable to demonstrate a primary business purpose for traveling to the city where he maintains his personal residence, the expenses incurred are considered nondeductible personal expenses.

However, pursuant to Treas. Reg. § 1.162-2(b)(2) (1960), whether a trip is made primarily for personal or business motives is a question of fact to be determined by a consideration of all the circumstances. Considering all the facts, the district court found the taxpayers moved to Reno primarily for the purpose of serving with the Guard. 433 F. Supp. at 1029. This finding was sufficiently supported by fact and adopted by the Ninth Circuit. 615 F.2d at 494. Accordingly, the court's allowance of a deduction for the taxpayers' travel expenses incurred between their primary and secondary places of employment is consistent with the Government's interpretation of § 162(a)(2). Treas. Reg. § 1.162-2(b)(1) (1960). The fact that the taxpayers also maintained personal residences at the minor employment was of little importance.

One aspect of the court's opinion that raises concern is its suggestion that the taxpayers "could, consistent with its determination of their 'tax homes,' claim deductions for substantiated overnight expenses incurred in Reno on days which they served with the Guard"; 615 F.2d at 498 n.14. This statement, although dictum, does not appear to be within the general consensus of the law, nor does it further the policy of § 162(a)(2), to account for the duplicative expenses incurred while traveling away from home.

The general rule under § 262 is that the maintenance of a taxpayer's family residence, and the expenses incurred in travel to and from his job, are strictly nondeductible personal expenses. See Commissioner v. Flowers, 326 U.S. 465 (1946). However, Rev. Rul. 75-432, 1975-2 C.B. 60, 61, provides an exception to this rule in those unusual situations when the employee maintains a permanent residence for that employee's family at or near the minor or temporary post of duty, and another residence at or near the principal post of duty. Since the employee is traveling away from the principal post of duty on business where the employee also maintains a residence, the cost of meals and lodging at the minor or temporary post of duty is allowed as a deduction. Of course, the deduction is limited to that portion of the family expenses for meals and lodging that is properly attributable to the employee's presence there in the actual performance of business duties.


Although the taxpayers' "tax homes" were located in their principal place of business, they did not maintain a residence at such "tax home." When they were "away from home" while in Reno, they did not incur the duplicative costs for lodging as did the taxpayers in Coombs. Because they did not maintain a residence at, and only rented hotel rooms when they performed duties at, their principal place of business, they would not qualify for the exception under Rev. Rul. 75-432.
ers’ principal place of employment. Once the principal place of employment was determined, the Ninth Circuit summarily held that the taxpayers’ “tax homes” were their personal abodes in their principal employment locale.\(^{139}\)

As a result of the Ninth Circuit’s decisions in *Coombs* and *Folkman*, the rule that one’s “tax home” is one’s personal residence or abode is firmly entrenched. Because of the mitigation requirement in *Coombs*, however, the primary beneficiaries of this rule will be construction workers who work in remote locations and are forced to live away from the general locale of their employment. Because construction projects such as nuclear testing facilities, missile sites, dams, and remote highway and logging projects provide so few of the amenities of civilized living, it appears that the Ninth Circuit was unwilling to recognize these places as a taxpayer’s “home” for tax purposes.

*The Location of Taxpayers’ Principal Place of Business Appears to be Where They Earn the Most Income*

Through adoption of the test announced by the Sixth Circuit in *Markey v. Commissioner*,\(^{140}\) the Ninth Circuit now has a clear method of analysis by which to determine a taxpayer’s principal place of business. *Folkman*, where the Ninth Circuit first applied this three-prong definitional approach, is significant in two respects. Initially, it refines the factual approach that the court had previously taken to determine which of two or more possible places constituted one’s principal place of business or employment. In addition, it places the Ninth Circuit directly in line with the position of the Government on this issue.\(^{141}\)

In *Folkman*, prior to any determination of the actual physical location of the taxpayers’ “tax homes,” the Ninth Circuit had to determine which of two possible places qualified as the princi-
pal place of employment. Through use of the Markey test, the court focused on three principal factual considerations in order to make its determination: (1) The length of time the taxpayer spent at each location; (2) the taxpayer's degree of business activity at each location, and (3) the financial return to the taxpayer with respect to each location.

In this regard, the court's approach was clearly a refinement of what had previously been a general factual inquiry, as evidenced in Wills v. Commissioner and Frank v. United States. In Wills, the court held that the "tax home" of a professional baseball player was in Los Angeles, where his team's ballpark was located. Although it did not apply a bright-line test, the court determined Los Angeles to be the taxpayer's principal place of employment, even though the taxpayer maintained his family residence in Spokane, Washington, where he also earned a small portion of his income. In Frank, a taxpayer maintained a residence and earned a substantial portion of his income in Oregon. However, he was employed as a congressional assistant in Washington, D.C., where he spent a significant amount of his employed time. The court, in stating that the location of one's "tax home" was a question of fact, held the taxpayer's principal place of business was in Oregon where he earned most of his income. Although the court recognized that the determination of one's principal place of business involved a question of fact, neither decision had yet suggested a clear method of analysis.

With its decision in Coombs, the Ninth Circuit recognized the difficulty in determining one's "tax home" when one earns a substantial income and resides in each of two or more locales. The court specifically referred to Folkman, which at that time

142. See 615 F.2d at 495-96.
143. Id. at 496.
144. 411 F.2d 537 (9th Cir. 1969).
145. 577 F.2d 93 (9th Cir. 1978).
146. 411 F.2d at 540.
147. 577 F.2d at 96-97.
148. Id. The court considered the taxpayer's net income in each city, and the fact that the taxpayer maintained a business office in Portland, Oregon throughout the time he was on the Senate staff.
149. 608 F.2d at 1275 n.2.
was docketed for appeal before the Ninth Circuit. The court stated in dictum, citing Markey, that where a taxpayer accepts permanent or indefinite employment away from his usual abode, the taxpayers' "tax home" will shift to the vicinity of the taxpayer's new principal place of business. Although Coombs did not set out the specific principal place of business test of Markey, the court's dictum on the shift of a taxpayer's "tax home" immediately followed its recognition of the problem presented by the then docketed appeal of Folkman. This implied that the Ninth Circuit might adopt the Markey test to determine one's principal place of business. As a result, when the Ninth Circuit in Folkman subsequently adopted the Markey test, it was not unexpected.

An additional element of significance to the tax practitioner is that the Folkman decision is consistent with the Commissioner's approach in determining one's principal place of business. The Commissioner's position, as announced in Revenue Ruling 54-147, uses the same three criteria as the Ninth Circuit. In fact, the court's decision on this issue, including those prior to Folkman, suggest that it focuses on the income element of the Markey test, as does the Commissioner. In Wills, Frank, and Folkman, the court found the taxpayer's principal place of business to be where the taxpayer earned most of his income. This finding is consistent with the approach taken in

150. Id. ("When the taxpayer both earns a substantial portion of his income and resides in each of two or more locales, the determination of the taxpayer's home is especially difficult. See Folkman v. United States, 433 F. Supp. 1022, 1026-29 (D. Nev. 1977), appeals docketed, Nos. 77-3531, 77-3352 (9th Cir. Nov. 1, 1977) and Markey v. Commissioner, 490 F.2d 1249 (6th Cir. 1974).")

151. 608 F.2d at 1275-76.

152. Id. See note 150 supra.

153. Notes 56 & 141 supra.

154. See note 156 supra. In Rev. Rul. 54-147, 1954-1 C.B. 51, 52, the Commissioner stated the third element of the test, the income element, "should be given great weight in cases where all the services are performed as an 'employee' ... ."

155. 411 F.2d at 540. Wills' principal place of business was found to be Los Angeles, where he was principally employed. He earned only $5,000.00 in Spokane, Washington, which the court found to be his secondary place of employment.

156. 577 F.2d at 97. The taxpayer in Frank earned $325,241.00 in Portland, Oregon, where the court found his principal place of employment, and only $4,801.00 in Washington, D.C., where the Government claimed it was.

157. In Folkman, although the taxpayers spent most of their time in Reno, Nevada, where their personal residences were, the Ninth Circuit found their principal places of business to be in New York and San Francisco, respectively, where they "derived the overwhelming portion of their income . . . ." 615 F.2d at 496.
Revenue Ruling 54-147. Where taxpayers earn most of their income as employees rather than from business operations, the Commissioner requires more emphasis be placed upon the third consideration of the test, the income element.

As a result of the consistencies in the positions of the Ninth Circuit and the Commissioner, and the fact that the Ninth Circuit now has a clearly delineated approach to determine one's principal place of business, the tax practitioner can plan accordingly with a greater degree of security. If one applies the three-prong Markey test, with a focus on its third element where the taxpayer is an employee, one's finding of a principal place of business will probably be the same as the Ninth Circuit's and the Commissioner's.

Section 162(a) Provides a Stronger Basis For Mitigation of Tax Liability Resulting from a Mandatory Meal Plan

The Ninth Circuit has provided two avenues by which employees required to participate in a meal plan as a condition of employment may avoid tax liability for the resulting expenses. In Sibla, where there were substantial employer imposed restrictions in connection with the taxpayers' meal expenditures, the Ninth Circuit allowed the taxpayers to elect either a deduction of the amount paid for meals under section 162(a), or an exclusion from income of the same amount pursuant to section 119.

Section 119

Section 119 allows employees to exclude from gross income the value of meals furnished them by their employer for the convenience of the employer. However, the Supreme Court in Commissioner v. Kowalski, and the Government in Treasury

158. See notes 56 & 141 supra.
159. See notes 56, 141 & 154 supra.
161. 434 U.S. 77, 84 (1977). See notes 18 & 101 supra and accompanying text. In Kowalski, the majority opinion written for seven justices stated:

By its terms section 119 covers meals furnished by the employer and not cash payments for meals. This is not a mere oversight . . . [t]he form of section 119 which Congress enacted originated in the Senate and the report accompanying the Senate bill is very clear: "Section 119 applies only to meals . . . furnished in kind." S. REP. No. 1622, 83rd Cong., 2d Sess. 190 (1954).
Regulation section 1.119-1(c)(2), specifically restricted section 119’s exclusion to apply to meals furnished “in kind.” Because the Ninth Circuit did not hold that the taxpayers actually met the “in kind” requirement, it appears that an exclusion should have been disallowed under the authority of Kowalski and Treasury Regulation section 1.119-1(c)(2).

Even though the Ninth Circuit recognized the implication of Kowalski, it reasoned that Sibla was closely analogous to the “in kind” situation, and that the taxpayers in Sibla substantially complied with the requirements of section 119. In fact, through its allowance of an exclusion, the court implicitly held that substantial compliance met the “in kind” requirement.

The Ninth Circuit’s reasoning is based on the distinction between Kowalski and Sibla in terms of the element of control that the taxpayers in each case had over the respective meal plans. In its restrictive interpretation of section 119 in Kowalski,

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162. Treas. Reg. § 1.119-1(c)(2) (T.D. 6745, July 9, 1964, 29 F.R. 9380) provides: “The exclusion provided in section 119 applies only to meals . . . furnished in kind by an employer to an employee.”

163. 611 F.2d at 1265.

164. Id. at 1264-65.

165. Id. at 1264. Although the employer did not directly purchase the food or supervise its preparation, and did not directly collect the money, these activities were conducted at the direction of the Fire Chief. In addition, the cook was appointed by the Fire Chief.

There is additional support for the Ninth Circuit’s reasoning. Although “furnished by the employer” is a threshold requirement for the application of § 119, it appears that it may be met either directly or indirectly. In Rev. Rul. 71-267, 1971-1 C.B. 37, the value of meals furnished by a private contractor retained by the employer for that purpose was held excludable under § 119. Tougher v. Commissioner, 51 T.C. 737, 745-46 (1969), aff’d per curiam, 441 F.2d 1148 (9th Cir.), cert. denied, 404 U.S. 856 (1971), held that a § 119 exclusion was unavailable to an employee who purchases supplies from his employer’s commissary, which the taxpayer then made into meals. The court gave as its reason the fact that when the meal is provided by the employer, “he can control the time, place, duration, value, and content of the meal to suit his convenience.”

One can argue that, based upon the above Revenue Ruling and the fact that the meals were required to be provided by the cook of the LAFD, the time, place, and duration of the meals were controlled by the taxpayers’ employer. Under this argument, the “by the employer” requirement of § 119 is substantially met. However, this still leaves the “in kind” requirement. The value and content of the meals were not shown to be controlled by the taxpayers’ employer.

The Ninth Circuit held that the distinction between absolutely “in kind” and the facts of this case was “too slender a reed upon which to hang tax liability.” 611 F.2d at 1265.
the Supreme Court made repeated references to *Commissioner v. Glenshaw Glass Co.* This implied a focus by the court upon the benefit bestowed the employee due to his receipt of cash. Thus in *Kowalski*, the receipt of cash meal allowances represented a “clear accession to wealth” over which the taxpayer had complete dominion. In *Sibla*, the taxpayers received no cash allowance over which they could exercise control, but were required to pay for the meals distributed at the station house whether they ate them or not. Based upon these distinctions, the Ninth Circuit held *Kowalski* inapplicable to the *Sibla* situation. Although the court’s reasoning has some merit, such substantial compliance should not be taken to meet the “furnished in kind by the employer” test.

As Judge Kennedy pointed out in his dissent, the taxpayer’s control over the meal plan was not completely restricted. The taxpayers exercised a certain degree of control over their meal plans; each taxpayer was allowed to choose what he desired for his meal period. The failure of the record to adequately disclose the degree of the taxpayers’ control in the mess plan should not be used as a factor for the court to bolster its “substantially in kind” reasoning. If the court kept within *Kowalski*’s strict interpretation of section 119, the failure of the record to disclose the taxpayer’s degree of control should lean more toward disallowance of an exclusion.

There is an additional element of concern in the Ninth Circuit’s allowance of the section 119 exclusion. This concern stems from a failure of the record to disclose a requirement in the mess plan that each taxpayer pay a fixed amount for meals. If the taxpayers are not bound by such a requirement, their freedom of choice of meals is increased. Not only does this add to the taxpayers’ control over the mess plan, but also, if an employee does

166. 348 U.S. 426 (1954). In *Glenshaw Glass*, the Court held that an exemplary damage award received by the taxpayer was includable in gross income because it was money over which the taxpayer had complete dominion, and as such, it was a “clear accession to wealth.” *Id.* at 431.
168. 611 F.2d at 1265.
169. *Id.* at 1266.
170. *Id.*
not pay an "unvarying amount" for his or her meals, the re­
quirements of Treasury Regulation section 1.119-1(a)(3)(ii) are
not met.

This section provides:

If an employer furnishes to an employee meals for
which the employee is charged an unvarying
amount . . . irrespective of whether he accepts
the meals, the amount of such flat charge made
by the employee for such meals is not, as such,
part of the compensation includable in the gross
income of the employee . . . .171

Assuming that the Ninth Circuit is correct in holding Ko­
walski inapposite to the Sibla situation, the taxpayers still failed
to meet the "fixed amount" requirement of Treasury Regulation
section 1.119-1(a)(3)(ii).

Given the fact that the taxpayers only substantially com­
plied with the "in kind" requirement of section 119, coupled
with a failure of the record to disclose that the taxpayers paid a
fixed amount for their meals, the Ninth Circuit's allowance of an
exclusion under section 119 is questionable. This is especially so
in light of the restrictive interpretation of section 119, advanced
by Kowalski. The meals were not in fact furnished "in kind."

Section 162(a)

Section 162(a) provides a stronger basis for the court in its
effort to remove any tax liability on the part of the taxpayers
due to the mess fee requirements. This section provides: "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 . . . ."172 Thus, if a taxpayer can establish
that his expenses are an ordinary and necessary incident to the
performance of his trade or business, and are directly related,
they are deductible from his gross income pursuant to section
162(a).173

172. I.R.C. § 162(a).
173. Treas. Reg. § 1.162-1(a) provides: "Business expenses deductible from gross in­
come include ordinary and necessary expenditures directly connected with or pertaining
to the taxpayer's trade or business . . . ."

The expenditures of the taxpayers in this case were not only ordinary and necessary
Although ordinary and necessary business expenses are deductible under section 162(a), meal expenditures not incurred in travel away from home are generally considered nondeductible personal expenses under section 262. Along this line, the Commissioner argued that the taxpayer's meal expenditures were also nondeductible personal expenses because they would have been incurred anyway. However, as the Ninth Circuit pointed out, the Commissioner failed to recognize the position taken by the Internal Revenue Service in Revenue Ruling 75-316: "The fact that a particular expense may under certain circumstances be a nondeductible personal expense does not preclude the deduction of such an expense as an ordinary and necessary business expense under other circumstances."

Because the taxpayers incurred the mess expenses as a condition of their employment, the Ninth Circuit affirmed the majority opinion of the Tax Court and allowed the mess fee deductions under section 162(a). In consideration of the restrictive nature of the taxpayers' mess fee requirement, the allowance of such a deduction is not inconsistent with other courts' findings and the service's position where taxpayers' expenditures were considered personal.
Unlike its analysis under section 119, where the court had to stretch the "in kind" requirement and ignore the requirement that the taxpayers pay a fixed amount for their meals, the court under section 162(a) did not have to make such far-reaching arguments. Although meal expenditures not incurred in travel away from home are generally considered nondeductible personal expenses, they are also, if they meet the requirements of section 162(a), deductible from income as ordinary and necessary business expenses.

In summary, Siblea involved a situation where there were substantial employer-imposed restrictions in connection with the taxpayers' meal expenditures. As a result, the court has gone out of its way to allow the taxpayers to avoid an inequitable burden. The court provided relief in two ways: (1) allowing the taxpayer to choose to exclude the meal payments from his gross income under section 119, which is questionable in light of Kowalski; and (2) allowing him to deduct the amounts pursuant to section 162(a) as business expenses. Although this type of meal deduction is not usually seen wider this section, the restrictive nature of the conditions justifies it.

E. CONCLUSION

The more restrictive the nature of the taxpayer's expense requirement, the more willing the Ninth Circuit was to provide an avenue from which the taxpayer was able to mitigate his tax burden. In Coombs, the court achieved this result by affirming the traditional rule on the location of "tax home" in the Ninth Circuit; it is at the taxpayer's personal residence or abode. However, it appears the Ninth Circuit requires taxpayers to mitigate their expenses and maintain their personal residences or abodes in or as near the city of their employment as is reasonably possible.

fact that the clothing was suitable for normal wear in certain lifestyles was not controlling because the taxpayer preferred a more simple lifestyle.

In Inman v. Commissioner, 29 T.C.M. 1168 (1970), a forest ranger was required to live in a Park Service house and pay his own utility bills. The court allowed the taxpayer to deduct a proportionate share of his lodging related expenses.

Rev. Rul. 58-382, 1958-2 C.B. 59, provided for a deduction of the expenses related to a twice yearly medical examination of a pilot who was required at his own expense to obtain a satisfactory medical certificate. Because this was required by the taxpayer's employer, it was deductible as an ordinary and necessary expense pursuant to § 162(a).
Before application of the "tax home" rule in Folkman, the court had to determine the location of the taxpayers' principal place of business. The court in this vein adopted the Markey test. With a determination of the principal place of business, and hence the "tax home," the taxpayers were able to deduct travel expenses incurred between their primary and secondary places of employment.

Finally, in Sibla, the court provided two avenues of relief for taxpayers who were required as a condition of their employment to participate in a mandatory meal plan at their own expense. Initially, the court provided for a business expense deduction under section 162(a). Although unusual, it was justified by the restrictive nature of the taxpayers' job requirements. In addition, the court allowed for an exclusion of the same amount from income under section 119. This result is questionable in light of Commissioner v. Kowalski, where the Supreme Court held that in order for the value of meals to be excluded from a taxpayer's income under section 119, the meals must be furnished to the employee in-kind.

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II. THE SALE OF "ALMOST PATENTED" PROPERTY TO A RELATED PERSON WILL NO LONGER BE TAXED AT CAPITAL GAINS RATES IN THE NINTH CIRCUIT

A. INTRODUCTION

In Myers v. United States, the Ninth Circuit held that for the purposes of section 1239, "almost patented" property is to be considered property subject to the depreciation allowance


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1. 613 F.2d 230 (9th Cir. 1980) (per Cordova, D.J., sitting by designation; the other panel members were Kennedy, J. and Hug, J.).

2. I.R.C. § 167. Internal Revenue Code § 167 provides: "There shall be allowed as a depreciation deduction a reasonable allowance for exhaustion, wear and tear . . . (1) of property used in the trade or business, or (2) of property held for the production of income."
provided for in section 167. Thus, as "almost patented" property, a transfer to a controlled corporation of a patent application for which the United States Patent Office has issued a notice of allowance, falls within the purview of section 1239. The proceeds from the sale of such property will therefore be taxed as ordinary income.

B. FACTUAL BACKGROUND

June L. Myers (Taxpayer), the widow of John W. Myers, was the sole owner of all the issued and outstanding stock of Myers Electric Products, Inc. (Myers Electric). John W. Myers initially filed patent application number 439,533 with respect to his invention, a coupling for electric conduits, on June 28, 1954. On December 1, 1958 he filed a second patent application, number 777,321, which was a continuation of patent application number 439,533. Patent application number 777,321, consisting of three claims, was rejected in its entirety by the Patent Examiner on January 30, 1959. Upon appeal, the Examiner's decision was reversed by the Board of Appeals as to claims one and two on January 2, 1963. On January 31, 1963 a "Notice of Allow-

3. I.R.C. § 1239, in effect at the time of Taxpayer's transaction, provides in pertinent part:

(a) TREATMENT OF GAIN AS ORDINARY INCOME —
In the case of a sale or exchange, directly or indirectly, of property described in subsection (b) (between "related persons") . . . any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) SECTION APPLICABLE ONLY TO SALES OR EXCHANGES OF DEPRECIABLE PROPERTY. This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

4. For the purposes of Myers' transaction, a controlled corporation under § 1239(a)(2) of the Internal Revenue Code of 1954 (now I.R.C. § 1239(b)(2)), is one where the taxpayer owns more than 80% in value of the outstanding stock.


6. Id. at 88,003. Upon filing of patent application number 777,321, patent application number 439,533 was abandoned.
"ance" was mailed with respect to Patent Application Number 777,321.7

Upon John W. Myers' death on September 19, 1959, Taxpayer, as qualified Administratrix of decedent's estate, intervened and assumed protection of the patent.8 After assigning the estate's interest to herself, Taxpayer, on June 29, 1963, granted Myers Electric the "sole and exclusive right, privilege and license to use, manufacture, produce, distribute and sell" the invention covered by patent application number 777,321 for a period of twenty years.9 In exchange for the transfer, Myers Electric agreed to pay royalties on gross sales to Taxpayer.10 On Taxpayer's federal income tax returns for 1967 through 1974, she claimed the royalty payments as ordinary income.11 After the June 29, 1963 transfer date, Myers Electric paid the $30.00 filing fee required by the Patent Office, and on September 17, 1963, letters patent were issued with respect to patent application number 777,321.12 This case appeared before the district court and on appeal before the Ninth Circuit in the posture of a tax refund suit.

Finding that the transferee merely had to pay the $30.00 filing fee in order for letters patent to issue, the district court held that the patent application had "sufficiently matured" so as to constitute property of a character subject to an allowance for depreciation within the provisions of section 167.13 As a result, the district court found that Taxpayer's sale of the property to Myers Electric, a corporation she wholly controlled, should necessarily be governed by section 1239.14 Section 1239 provides

7. Id.
8. Id. Taxpayer notified the United States Patent Office on May 29, 1963 that she had assumed protection of patent application number 777,321.
9. Id. The estate's interest was 90%, because Mr. Myers had previously transferred a 10% interest to one Brodie Ahlport in 1954. Mr. Ahlport also assigned his 10% interest along with Taxpayer to Myers Electric.
10. Id.
11. Id.
12. Id. The payment of the filing fee was essential to the issuance of letters patent.
13. The court relied upon the reasoning of Estate of Stahl v. Commissioner, 442 F.2d 324 (7th Cir. 1971), and also referred to Davis v. Commissioner, 491 F.2d 709 (6th Cir. 1974). The patent application had been transferred to Myers Electric five months after the notice of allowance had issued, and three months prior to the issuance of letters patent. Id. at 88,004.
14. Id. at 88,004-05.
that where an individual sells to a related person, property which is of a character subject to depreciation under section 167, any income recognized by the individual taxpayer should be considered ordinary income.

The district court found Taxpayer’s actions to be of the type section 1239 was intended to scrutinize. Section 1239 was designed to prevent situations where a taxpayer, owning property with a marketable value substantially in excess of the taxpayer’s basis in the property, transfers such property to a related corporation at its market value. In such a situation, at only the cost of a capital gains tax, the taxpayer continues in control of the property by way of his or her control over the corporation. At the same time, the corporation is able to step up the basis of the transferred property and take greater depreciation deductions against ordinary income. The district court found the capital gains provision to be strictly interpreted, and that Taxpayer’s income was correctly reported as ordinary income.

C. THE NINTH CIRCUIT’S REASONING

In its opinion, the Ninth Circuit focused on two questions: whether patent application number 777,321 was property of a character subject to depreciation in the hands of Taxpayer; and if so, whether any gain recognized on the sale to Myers Electric was ordinary income under section 1239. As did the district court, the Ninth Circuit found that section 1239 was intended to prevent taxpayers from selling appreciated property to a controlled corporation at the cost of a capital gains tax, while maintaining control over the asset and reaping the benefit of depreciation deductions against ordinary income through a stepped-up

15. Internal Revenue Code of 1954, § 1239(a)(2) (now I.R.C. § 1239(b)(2)) defined a “related person” as “an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and grandchildren . . . .” See note 4 supra.


17. Id. (citing S. REP. No. 781, 82nd Cong. 1st Sess. 29 (1951)).

18. 77-2 U.S. Tax Cas. at 88,004-05.

19. Id. at 88,005. For a broad reading of Code § 1239, in that the term “property of a character which is subject to the allowance for depreciation” should be interpreted so as to apply to the transaction in Myers, in order to limit the classes of transactions qualifying for capital gains, the court relied on Commissioner v. Gilette Motor Co., 364 U.S. 130 (1960) and Corn Prods. Co. v. Commissioner, 350 U.S. 46 (1955).

20. 613 F.2d 230, 231 (9th Cir. 1955).
basis. In determining whether this particular patent application constituted depreciable property to be governed by section 1239, the court focused on the “evolutionary process” of a patent. At one end of the scale is a patent application, bearing with it assignable property rights but no determinable useful life upon which to base depreciation. At the other extreme is the patent, which without dispute, is depreciable and falls within the purview of section 1239. The patent application at issue was at neither extreme. To allow Taxpayer’s patent application to fall outside the purview of section 1239, however, would thwart the purpose of that section.

The court found that there is a point on the evolutionary scale where the possibility of issuance of letters patent becomes overshadowed by the actual probability of issuance. In order to determine whether Taxpayer’s patent application had crossed the line to probability of issuance, and therefore should be governed by section 1239, the Ninth Circuit adopted part of the Seventh Circuit’s reasoning announced in Stahl v. Commissioner. Under the Stahl doctrine, where an official notices of allowance is received by the transferor prior to the sale of a patent application, the patent application will be considered “sufficiently matured” so as to qualify as a patent under section 1239. If a patent application is “virtually certain to mature into a depreciable patent . . . with the merest of diligence by the transferee in processing the applications after the sale, a mechanistic distinction between patents and those patent applications which have been the subject of official indications of allowability is unwarranted.”

21. Id.
22. Id. The court recognized that patent applications go through an “evolutionary process” which includes a patent application, a letter of appearance of allowability, a formal notice of allowance, and finally the issuance of letters patent.
23. 613 F.2d at 231 (citing Hershey Mfg. Co. v. Commissioner, 43 F.2d 298 (10th Cir. 1930) (longstanding authority for the rule that actual patents are depreciable property)).
24. 613 F.2d at 232. Although not noted in the Ninth Circuit’s opinion in Myers, the Tax Court followed a test similar to that announced in Stahl v. Commissioner. See Davis v. Commissioner, 491 F.2d 709 (6th Cir. 1974), aff’d per curiam, 31 T.C.M. (B.N.A.) 1155 (1972); Eckel v. Commissioner, 33 T.C.M. (B.N.A.) 147 (1974).
25. 442 F.2d 324 (7th Cir. 1971).
26. 613 F.2d at 232.
27. Id.
In distinguishing *Chu v. Commissioner*, a case asserted by Taxpayer as explicitly rejecting the *Stahl* doctrine, the court noted that in *Chu*, the taxpayer merely received notification of the possible issuance of a patent by the receipt of a letter of appearance of allowability. *Chu* had not received a formal notice of allowance, which under the Ninth Circuit's rationale would be more akin to the probable issuance of a patent. The Ninth Circuit stated that the First Circuit in *Chu* attempted to apply the reasoning of *Stahl*, but could not because a notice of allowance had not been issued to the taxpayer in *Chu*. As a result, *Chu* was factually distinguishable.

The court rejected Taxpayer's further contention that she was entitled to rely upon the law as it existed at the time of the transfer. The *Myers* panel found her claim to be without merit because she did not actually rely on the law extant at the time of the transfer, nor did she treat the proceeds from the sale as capital gains.

In conclusion, the panel found that the letters patent would have issued upon payment of the final $30.00 fee in the normal

28. 486 F.2d 696 (1st Cir. 1973).
29. 613 F.2d at 322. The Ninth Circuit noted that in *Chu*, the taxpayer assigned his patent application after the Patent Office had informed him that only six minor claims of his original 18 claims appeared allowable, while the crux of the patent application was disallowed. A notice of allowance was issued only after an amended application was filed after the transfer.
30. 613 F.2d at 352.
31. *Id.*
32. The relevant tax law extant in 1963 was Code § 1239 and the regulations promulgated thereunder. Taxpayer, before the Ninth Circuit, relied upon a Solicitor's Memorandum issued in June 1928, which stated that applications for patents are generally not property subject to depreciation. S.M. 5038, C.B. V. I, Jan. - June, 1928, at 247. (Both parties conceded that at the time of the transfer there was no case law on the subject. *Id.*) 

In addition, Taxpayer claimed that she should not be governed by Rev. Rul. 67-136, 1967-1 C.B. 58, which, issued in 1967 — after the transfer — provided that patent applications are subject to depreciation when letters patent will issue in the normal course of events. *Id.*

The Ninth Circuit rejected Taxpayer's arguments on the ground that Taxpayer did not actually rely on the Solicitor's Memorandum of 1928. The court also stated that applications for letters patent are not property subject to depreciation. 613 F.2d at 253. At the time Taxpayer filed her returns, she treated the proceeds from the sale of the patent application as ordinary income, and not as capital gains; the Ninth Circuit found it obvious that Taxpayer did not rely on the Solicitor's Memorandum. 613 F.2d at 232. As a result, the court did not address the issue of whether Taxpayer had a right to rely on the Solicitor's Memorandum.
course of events. Under these circumstances, the patent application had "matured," and was subject to a section 167 depreciation allowance. Therefore, the proceeds from the sale of the application to Myers Electric, Taxpayer's wholly owned and controlled corporation, were correctly treated as ordinary income under section 1239.

D. ANALYSIS OF THE NINTH CIRCUIT'S REASONING

Legislative Intent of Section 1239 Upheld

With the Myers decision, the Ninth Circuit has closed what was a loophole in the Code. Taxpayers, at least in the Ninth Circuit, will no longer be able to transfer "almost patented" property to their controlled corporations without recognizing ordinary income. Rather than take a restrictive reading of the statutory language, the Ninth Circuit focused on the spirit and legislative intent of section 1239. Clearly the decision is consistent with the purpose of the section which provides as follows:

In the case of a sale or exchange of property . . . between related taxpayers, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to an allowance for depreciation provided for in section 167.

Whether "almost patented" property constitutes "property of a character subject to a depreciation allowance under section 167," a threshold requirement of section 1239, is an issue pre-

33. 613 F.2d at 232.
34. Id. at 233.
35. In order for a taxpayer to come within the purview of Code § 1239, the taxpayer must cross the 80% or more ownership threshold of Code § 1239(b)(2) or (b)(3), unless the two related taxpayers are husband and wife, in which case there is no 80% requirement. Additionally, to determine constructive ownership of stock, Code § 1239(c) invokes the attribution rules of Code § 318. Note that the result in Myers remains unchanged by the Tax Reform Act of 1976 and the Revenue Act of 1978.
36. With the Ninth Circuit's decision that "almost patented" property is property of a character subject to an allowance for depreciation, Code § 1239(a) would require that any gain recognized by a taxpayer on transfer of "almost patented" property to a related person as defined by Code § 1239(b) be treated as ordinary income. See I.R.C. § 1239(a).
37. I.R.C. § 1239(a). Other than for the definition of a "related taxpayer," which was not at issue in the instant case, see note 39 infra, current Code § 1239(a) is no different in substance than § 1239(a) and (b) of the 1954 Code, which were in effect when the transfer in issue took place. Therefore, unless otherwise specified, current Code § 1239 will be used for the purpose of analysis.
viously undecided by the Ninth Circuit. Had the court read section 1239 literally, without consideration of its purpose, Taxpayer would have been able to avoid its grasp. Transfers of non-patented property would generally be considered outside the purview of section 1239, as not being of a character subject to depreciation under section 167.\(^4\)

Not only was the particular issue in *Myers* one of first impression for the Ninth Circuit, but there was little decisional authority outside the circuit for which the panel could look for guidance. Although there is little case law that directly addresses the issue in the instant case, a literal application of section 1239 would have placed a premium upon compliance with the mere formalities of that section while ignoring its purpose and substance. If the section was inapplicable until property transferred between “related taxpayers” was actually patented, it would be subject to flagrant abuse. In fact, “related taxpayers” might be able to completely avoid the application of section 1239 to their transfers of “almost patented” property. For example, assume the scenario wherein a taxpayer applies for letters patent on a low basis, highly appreciated invention. When and if a formal notice of allowance is issued on the patent application, the taxpayer then transfers his or her rights in the patent to a “related taxpayer.” Upon payment of the final filing fee by transferee, the Patent Office issues letters patent. Because the patent would

39. Section 1239(a) of the 1954 Code required that the transaction take place between “related taxpayers” as does current Code § 1239. However, current Code § 1239 defines a “related taxpayer” more broadly. See notes 4 & 15 supra. Because Taxpayer in *Myers* owned 100% of the outstanding stock of Myers Electric, the “related taxpayer” threshold is not at issue.

40. Section 167 of the Code provides that “[t]here shall be allowed as a depreciation deduction a reasonable allowance for exhaustion, wear and tear . . . (1) of property used in a trade or business, or (2) of property used for the production of income.” Treasury Regulation § 1.167(a)-3 provides that because of their determinable useful life, patents are intangibles which are subject to an allowance for depreciation. Treas. Reg. § 1.167(a)-3 (1976). See Hershey Mfg. Co. v. Commissioner, 43 F.2d 298 (10th Cir. 1930). While it is undisputed that patents, if used in a taxpayer’s trade or business are considered depreciable under Code § 167, as a general rule, patent applications are considered intangibles with an indeterminate useful life, and therefore nondepreciable. Chu v. Commissioner, 486 F.2d 696 (1st Cir. 1974); Davis v. Commissioner, 74-1 U.S. Tax Cas. (CCH) ¶ 9321, 83,430 (1974). The Treasury Regulations make no provision for patent applications. Although nondepreciable as a general rule, patent applications have been held depreciable by some courts. See Stahl v. Commissioner, 442 F.2d 323 (7th Cir. 1971); Best Lock Corp. v. Commissioner, 31 T.C. 1217 (1958); Century Tank Mfg. Co. v. Commissioner, 18 T.C.M. (CCH) 430 (1959); see Rev. Rul. 67-136, 1967-1 C.B. 58, cited in *Myers* v. Commissioner, 613 F.2d at 232.
now be considered a depreciable asset, whose basis in the hands of the transferee would be stepped-up to its purchase price, the transferee could take greater depreciation deductions against ordinary income than could the transferor. Moreover, at only the expense of a capital gains tax, the transferor would enjoy the tax benefits that inure to the transferee because of his or her control over the transferee. This is precisely the result sought by the taxpayer in Myers.

Recognizing this potential for abuse, the Ninth Circuit applied section 1239 in an effort to further its policy and legislative intent. Through enactment of section 1239, Congress sought to prevent the practice of selling low basis, highly appreciated capital assets to a spouse or controlled corporation, where the transferee would obtain a stepped-up cost basis in the asset and thereby be able to take greater depreciation deductions than could the transferor. Congress recognized that because the transferor still had control of the asset, the tax benefit would rebound to that transferor at the cost of only a capital gains tax on the proceeds of the transfer. Congress again asserted its intent for

41. See note 40 supra.
42. Code § 1012 provides that the basis of purchased property in this case would be its cost.
43. Under Code § 1221, a patent application would be considered a capital asset, and its sale would generally yield capital gains.
44. STAND. FED. TAX REP. (CCH) ¶ 4757.03, at 54,240 (1979), which suggests that the "beauty of [such a scenario] is that, if the invention is later patented by the purchasing corporation, it will become depreciable at that time." However, CCH does caution that "if the patent has been applied for on the invention and if it is virtually certain that the patent will issue in due course, section 1239 . . . cannot be avoided, at least in the Seventh Circuit." Id. at 54,241 (referring to Stahl v. Commissioner, 442 F.2d 324 (7th Cir. 1971)).

There is particular reason to fear abuse in the transfer of patent applications to a close corporation where the close corporation is a Subchapter S corporation. This fear follows from the basic premise that a Subchapter S corporation itself pays no tax on its income, except capital gains in certain instances. Income is passed through the corporation and becomes the income of the shareholders to be reported on their individual returns. I.R.C. § 1373; Treas. Reg. § 1.1373-1(a), (e) (1978). Thus, there is no double tax (tax at both the corporate and shareholder levels), and the controlling shareholders receive substantial benefits on the transfer.
45. 613 F.2d at 231.
46. H. R. REP. No. 586, 82nd Cong., 1st Sess. (1951); S. REP. No. 781, 82nd Cong., 1st Sess. 29 (1951). See MERTENS, THE LAW OF FEDERAL INCOME TAXATION CODE, § 1239 (1979); 4 TAX MNGM'T (BNA) Primary Sources, Series II, § 1239 (1977). Although § 1239 was not intended to enjoy broad application, such intent was directed toward the definition of "related taxpayers," and not the definition of depreciable property. MERTENS, THE LAW OF FEDERAL INCOME TAXATION, CODE, § 1239 at 95 (1979).
scrutiny of such transactions in the Tax Reform Act of 1976, in which it sought to broaden the definition of "related taxpayers" in order to prevent abuse of the term by those attempting to avoid section 1239.47

Although Congress specifically defined the participants in a section 1239 transaction,48 it was less specific in its description of the applicable property. Section 1239(b) of the Internal Revenue Code of 195449 defines property within its purview as "property of a character which is subject to the allowance for depreciation provided in section 167."50 Because section 1239 does not specifically restrict its application to actual depreciable property, but uses the term "property of a character" subject to a depreciation allowance, it leaves room for judicial interpretation. The court's finding that during the evolutionary process of a patent51 there is a point at which the probability of the issuance of letters patent outweighs the possibility of issuance, provides the basis for its interpretation of section 1239.52 However, lacking precedent in the circuit to determine whether a patent application at such a point should be considered depreciable for the purposes of section 1239, the court looked to the Seventh Circuit's decision in Stahl v. Commissioner.53

On similar facts, the Seventh Circuit in Stahl held that where a transferor receives a notice of allowance prior to sale, the patent application is sufficiently matured so as to constitute depreciable property for the purposes of section 1239.54 The

48. I.R.C. § 318 is incorporated by reference in § 1239(c) and maintains specific rules in determining constructive ownership of stock.
49. I.R.C. § 1239(a).
50. I.R.C. § 1239(b) (1954) (now I.R.C. § 1239(a)) (emphasis added).
51. 613 F.2d at 232. The court found that patent applications proceed along the continuum from the initial patent application, through the letter of appearance of allowability, the official notice of allowance, and finally the issuance of letters patent. 613 F.2d at 231. See note 22 supra.
52. 613 F.2d 232.
53. 442 F.2d 324 (7th Cir. 1971).
54. 442 F.2d at 328. The facts in Stahl are similar to those in Myers insofar as the
transferee had only to exercise the "merest of diligence" in processing the application to obtain letters patent. Under the basic premise of the Stahl rationale, the Ninth Circuit recognized that a mechanistic distinction between an actual patent and a patent application coupled with a notice of allowance was unwarranted. The distinction would allow a transferee, through a ministerial duty in the normal business course, to transform what would be considered a non-depreciable patent application into a depreciable patent without being subject to the scrutiny of section 1239. In this regard, the Ninth Circuit's decision is clearly within the "mere diligence" rationale of Stahl, and moreover, furthers the policy of section 1239. The court has effectively prevented section 1239 from becoming an elective provision with regard to transfers of patent applications.

The Ninth Circuit is Unlikely to Consider Patent Applications Depreciable Prior to the Issuance of a Notice of Allowance

While the Ninth Circuit properly adopted that part of the Stahl rationale which applies section 1239 to transfers of patent applications coupled with a notice of allowance, it did not adopt the complete holding of Stahl. Not only did the Stahl court apply section 1239 to transfers of patent applications coupled with a notice of allowance, it also extended section 1239's threshold to an even earlier point along the evolutionary continuum, the point at which a notice of appearance of allowability patents transferred were accompanied with a notice of allowance. In Stahl, the taxpayer also transferred one patent application coupled only with a letter of appearance of allowability. 442 F.2d at 327-28. A patent application coupled with a letter of appearance of allowability was not at issue in Myers, nor did the Ninth Circuit adopt that part of the Stahl holding.

55. 442 F.2d at 328.
56. 613 F.2d at 231-32.
57. In Myers the transferee had only to pay the $30 filing fee required by the United States Patent Office in order to obtain letters patent. Id. at 231. Clearly this was a ministerial duty.
58. In addition, the Ninth Circuit's decision is consistent with the position of the Internal Revenue Service announced in Rev. Rul. 67-136, 1967-1 C.B. 58. Although issued after Taxpayer's transfer in Myers, the Revenue Ruling provides that if the invention covered by the patent application is one for which a patent will issue in the normal course of business, and the purchase price is fixed as a percentage of earnings over its life, it is considered depreciable. Rev. Rul. 67-136, 1967-1 C.B. 58, 59.
59. See notes 17, 21 & 46 supra.
60. 613 F.2d at 232. The Ninth Circuit's decision in Myers effectively moves the threshold for invoking § 1239 to the point at which an official notice of allowance has been issued and where the patent will issue in the normal course of events.
Because a patent application coupled with a notice of appearance of allowability occurs at an even earlier point along the evolutionary life of a patent, it may require more than the merest of diligence on the part of the transferee in order to become an actual patent. Given the opportunity, it appears unlikely that the Ninth Circuit would find such a patent application "sufficiently matured" so as to constitute depreciable property under section 1239.

As initially noted by the First Circuit in *Chu v. Commissioner*, a patent application which only appears allowable may require more than mere diligence to obtain letters patent. In *Chu*, after the initial application for letters patent, the taxpayer received a letter of appearance of allowability as to five of his original eighteen claims; the heart of his application was rejected. Two later amendments over a period of two years led only to a similar letter on one other claim of the original eighteen. At this point, the taxpayer transferred his interest in the patent application to his controlled corporation. The corporation filed a third amendment and was issued a notice of allowance ten months after the transfer, a full three and one half years after the taxpayer was first notified that the patent application appeared allowable.

*Chu* illustrates the fact that more than mere diligence may be required to obtain letters patent where the application only appears allowable. The transferee was required to file an amended application after the transfer. In addition, it appears that the transferee could not be sure letters patent would issue after the amendment because the patent application was previously rejected three times. In this light, the First Circuit rejected the government's argument that the issue before the court

61. 442 F.2d at 328. The Seventh Circuit in *Stahl* held that both a patent application that received a letter of appearance of allowability as well as two applications that received official notices of allowance were sufficiently matured so as to constitute depreciable property for the purpose of § 1239.

62. 486 F.2d 696 (1st Cir. 1973). *Chu* involved a transfer of patent rights by a taxpayer to his controlled corporation prior to the issuance of a notice of allowance. In *Myers*, Taxpayer argued that the First Circuit in *Chu* expressly rejected the *Stahl* doctrine and so should the Ninth Circuit. However, the Ninth Circuit found both *Chu* and *Stahl* factually distinguishable and thus rejected Taxpayer's argument. 632 F.2d at 232.

63. 486 F.2d at 698.

64. Id. at 699.

65. Id.
should be governed by the *Stahl* doctrine.66 Though the First Circuit wished to "intimate no view" as the validity of the *Stahl* doctrine,67 the court held that "even assuming the validity of the *Stahl* doctrine, it is beyond doubt that the patent application at issue in this case had not sufficiently matured within the meaning of that decision so as to be considered a depreciable patent for the purposes of section 1239.68

Although the Ninth Circuit was able to factually distinguish *Chu*,69 it recognized that a patent application which only appeared allowable balanced more heavily toward the possibility of issuance of letters patent, and did not have the probability of issuance that adheres to a formal notice of allowance.70 Where the patent application is not virtually certain to mature upon the exercise of mere diligence by the transferee—such as payment of the filing fee in *Myers*—there is less fear of abuse of section 1239. For example, if a patent application that only appeared allowable was not approved subsequent to a transaction governed by section 1239, the transferor would have recognized

66. *Id.* at 702.

67. *Id.* The First Circuit had difficulty with the *Stahl* rationale, especially insofar as it dealt with letters of appearance of allowability. The First Circuit pointed out that the Seventh Circuit may have been too quick to assume that patent applications to which notices of allowance have issued will mature into patents with the merest of diligence in processing the application. 486 F.2d at 703 n.8. The court cited Rule 313 of the Rules of Practice of the United States Patent Office, and stated that the allowance may be withdrawn at any time prior to the issuance of letters patent for reason of mistake on the part of the Patent Office, fraud or illegality in the application, or other interference. However, as the First Circuit had only letters of appearance of allowability at issue, and then only on a portion of the patent application, its discourse on the withdrawal of the notice of allowance in relation to the *Stahl* doctrine was dictum. Its discussion does show, however, that a letter of appearance of allowability, which is issued at an earlier point in the evolution of a patent is a tenuous prediction of issuance of letters patent.

68. *Id.*

69. 613 F.2d at 232. The Ninth Circuit recognized the First Circuit in *Chu* was unable to apply the *Stahl* doctrine because *Chu* dealt with a letter of appearance of allowability as to only six of eighteen claims on a patent application while the heart of the patent application was rejected. 486 F.2d at 698-99. The *Stahl* doctrine applied to patents coupled with a notice of allowance or letters of appearance of allowability. 442 F.2d at 328. However, although the Ninth Circuit recognized that the First Circuit did not expressly reject the *Stahl* doctrine, it failed to point out the First Circuit's difficulty with that doctrine. See note 67 supra.

70. 613 F.2d at 232.
ordinary income on the transaction, while the controlled corporation would be unable to take depreciation deductions because the asset would still be considered non-depreciable. This would be a harsh result, and moreover, would not further the purpose of section 1239. Apparently, the Ninth Circuit tacitly recognized such a potential result when it determined that a patent application which appeared allowable had only a possibility of issuance of letters patent and not a probability of issuance. Based upon this finding, and the fact that it did not adopt the complete holding of Stahl, the Ninth Circuit would probably not extend the application of section 1239 to transfers that involve patent applications coupled only with letters of appearance of allowability.

E. CONCLUSION

The Ninth Circuit's decision in Myers supports congressional policy that transfers of depreciable property between "related taxpayers" be subject to scrutiny under section 1239. In the Ninth Circuit, a taxpayer cannot, without recognizing ordinary income, transfer to a "related taxpayer" a patent application which is the subject of a notice of allowance, where the patent will issue in the normal business course.

Where the seller, prior to the transfer, has been issued a notice of allowance on a patent application, the patent will probably issue upon the exercise of mere diligence by the transferee. Had the Ninth Circuit held section 1239 inapplicable to such a transaction, a seller could avoid section 1239 by holding a patent application until it is the subject of a notice of allowance, and then transfer it to a controlled corporation whereupon it will become a depreciable asset.

It appears unlikely, however, that the Ninth Circuit in the future will extend the threshold for invoking section 1239 to a

71. The asset would be considered a patent application, and hence non-depreciable as a general rule. See note 40 supra.
72. 613 F.2d at 231-32.
73. If the Ninth Circuit did adopt that part of the Stahl rationale which applied Code § 1239 to transfers of patents coupled with letters of appearance of allowability, it would have been considered dictum because such a patent application was not at issue. However, the court had an opportunity to indicate its future direction, but chose not to extend its rule to patent applications that appeared allowable.
patent application subject only to a letter of appearance of allowability. This letter occurs at an earlier point in the evolutionary life of a patent than does a notice of allowance, and there is less of a likelihood that such a patent application will become a patent in the normal business course. Hence, there is less fear for abuse of section 1239.

Robert C. Gabrielski*

III. THE PROPER TREATMENT OF BAD DEBT LOSS INVOLVING INTRAFAMILY LOANS

A. Introduction

In Hunsaker v. Commissioner, the Court of Appeals for the Ninth Circuit found that loans of large sums of money made by a son to his father and his father's corporation were not made in connection with the son's trade or business as required by section 166(1)(a) of the Internal Revenue Code (the Code). Thus, the losses from these loans were subject to short term capital loss treatment as nonbusiness bad debts under section 166(d) of the Code rather than deductible in full from the taxpayer's ordinary income. The court further held that the Tax Court erred as a matter of law in finding that payments made by the taxpayer as guarantor on certain performance bonds were deductible under section 166(f) of the Code which provides a limited exception to section 166(a) for guarantee agreements entered into prior to 1976. The court reaffirmed that the proper focus for determining worthless debt under section 166(f) is on the original obligation between the principal and creditor, and not on the guarantor's or indemnitor's claim against the principal.

B. Factual Background

Richard Hunsaker (Taxpayer) and his father were both engaged in land development, real estate, and other separate busi-

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1. 615 F.2d 1253 (9th Cir. 1980) (per Goodwin, J., the other panel members were Wallace and Farris, JJ.).
nesses prior to the years in issue. In 1965, Taxpayer's father organized a California corporation, SVH Investments (SVH), for the purpose of land development. Taxpayer loaned substantial sums of money to his father and SVH over a period of several years. The loans were evidenced by promissory notes at eight percent interest. The loans were used by Taxpayer's father in an attempt to keep SVH solvent. SVH had operated with a negative cash flow and had other financial difficulties between the years in issue. Taxpayer had never held stock in the corporation.

In 1968 Taxpayer became director of SVH after his father suffered an incapacitating stroke, and in 1969 he became vice president and chief operating officer. He received no salary or compensation for his services. Taxpayer's father died in 1969. Because the corporation was insolvent, Taxpayer was unable to collect the loans advanced to his father and SVH.

Taxpayer treated the losses from the uncollectible loans as business losses under section 166(a) of the Code and currently deducted the amount of the loss in full from his ordinary income. The tax commissioner asserted that the debt losses suf-

2. Taxpayer's main business was in the development and sale of real estate, having constructed and sold over 5,000 homes and buildings between 1954 and 1961. Many of these ventures were conducted in association with Taxpayer's father. Hunsaker v. Commissioner, 34 T.C.M. (CCH) 985,985 (1975).

3. Of the amounts advanced by Taxpayer to his father, $37,949.69 became uncollectible in 1968 and $38,214.80 in 1969. With respect to SVH, Taxpayer made direct advancements, $35,000 and $131,575 of which became uncollectible in 1968 and 1969, respectively. Id. at 985,988.

4. Advances (direct or indirect) to corporations by stockholders provide the most common examples of nonbusiness debts. See, e.g. Towers v. Commissioner, 247 F.2d 233 (2d Cir. 1957).

5. The loans Taxpayer made after he took control of SVH, following his father's stroke and subsequent death, were not aruged by Taxpayer to deserve separate tax treatment because he had assumed an active role in the affairs of the corporation. The Ninth Circuit noted that in light of Whipple v. Commissioner, 373 U.S. 193 (1963), Taxpayer would be prohibited from doing so. The Whipple court determined that furnishing regular services to a corporation without more is not a trade or business. As in Whipple, Taxpayer received no salary for his services. Furthermore, in United States v. Generes, 405 U.S. 93 (1972), the Supreme Court found that the taxpayer's relatively small salary from the corporation was insufficient to allow the taxpayer's indemnification losses as business bad debts which taxpayer claimed to have been made to protect his status as an employee.

6. Taxpayer's father's estate was insolvent. The father had owned over 80% of SVH.

7. I.R.C. § 166(a) provides:
   (a) General Rule:
ferred by Taxpayer were nonbusiness losses, thus deductible only as a short-term capital loss under section 166(d) of the Code.\(^8\) The Tax Court upheld the commissioner's finding, and Taxpayer appealed.

**Factual Background for Government's Cross-Appeal**

Shortly after the formation of SVH, Taxpayer's father began improving undeveloped land in Serene Lakes, California. In connection with this project Taxpayer's father and his partner, Frank Patty, the record owner of the Serene Lakes property, executed as principals faithful performance bonds funded by the surety, General Insurance Company of America, in favor of Sierra and Placer Counties. In 1967, Taxpayer purchased an irrevocable letter of credit and deposited it as collateral with the surety in favor of the County of Placer and Sierra Lakes County Water District concerning SVH's Serene Lakes project. Patty was required to be principal on the bonds because the county and water district required the record owner's signature.

In a separate agreement that became the primary focus of this cross-appeal, Taxpayer agreed to hold Patty (the second principal on the bond) harmless from any liability in connection with the performance bonds in consideration of Patty's promises...

1. Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

2. Partially worthless debts. When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

8. I.R.C. § 166(d) provides:

(d) Nonbusiness debts:

1. General Rule. In the case of a taxpayer other than a corporation

   (A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

   (B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

2. Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than

   (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

   (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.
to extend purchase options to SVH and to Taxpayer to repurchase the Serene Lakes property which Patty had acquired from SVH as security for loans he had advanced to the corporation in 1969 and 1970. Taxpayer was required to pay under the collateral agreement the expenses of completing the improvements on the property. Taxpayer was unable to recoup any of the costs of completing the improvements due to his father’s insolvency and his own hold harmless agreement with Patty.9

As guarantor on the bonds, Taxpayer deducted the amounts he paid on the performance bonds pursuant to section 166(f) of the Code.10 The Tax Court upheld Taxpayer’s treatment of the payments made on the performance bonds and the government took a cross-appeal.

C. THE COURT’S ANALYSIS

Taxpayer’s Appeal

On appeal, Taxpayer argued that the loans in question were made in direct connection with either his money lending or real estate business. He further contended that his sole motive in advancing money and credit to his father and SVH was to enter into a joint venture with his father concerning the Serene Lakes project.

The court first addressed the issue of whether Taxpayer was in the trade or business of lending money. A business bad debt deduction will not be allowed unless a taxpayer can establish that (1) he had a trade or business; and (2) the acquisition or

9. In 1969 and 1970, Taxpayer was required to pay $45,129.28 and $82,682, respectively, for expenses SVH could not pay under the terms of the collateral agreement. 34 T.C.M. (CCH) at 985,987 (1975).

10. I.R.C. § 166(f) states as follows:

A payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a guarantor, or endorser, or indemnitor on a noncorporate obligation the proceeds of which were used in the trade or business of the borrower shall be treated as a debt becoming worthless within such taxable year for purposes of this section (except that subsection (d) [nonbusiness debts] shall not apply, but only if the obligation of the borrower to person to whom such payment was made was worthless (without regard to such a guaranty, endorsement, or indemnity) at the time of such payment.
worthlessness of the debt was proximately related to it.\textsuperscript{11} Although Taxpayer had been heavily involved in financing arrangements during the years in issue,\textsuperscript{12} these arrangements were all found by the court to be integral to Taxpayer’s real estate business. Hence, Taxpayer failed to offer evidence of a genuine money lending business distinct from his real estate development business. The court relied on United States v. Henderson\textsuperscript{13} to determine that Taxpayer was not engaged in a trade or business to lend money. In Henderson, the court determined that although the taxpayer may have been in the business of loaning money during the years in issue, the “taxpayer was not involved in a continuous course of conduct of making loans, the purpose of which was the derivation of profits.” In addition, the Henderson court listed the following facts that led to the finding that the taxpayer was not engaged in a trade or business of lending money:

[N]either the taxpayer nor anyone acting on her behalf ever actively sought out the loan business; taxpayer never advertised that she was in a business of lending and did not maintain an office for that purpose; taxpayer’s activities in connection with the making of loans during this period were not treated as a business separated from her other interests—a separate office was not maintained, separate business books of account were not kept, and statements showing profit or loss from loan activities were not prepared; and finally, most of the borrowing was either by social or business acquaintances.\textsuperscript{14}

Relying on the reasoning and factors listed in Henderson, the Ninth Circuit concluded that Taxpayer had not been engaged in a separate trade or business of lending money. The court further determined that even if Taxpayer were able to show a genuine money lending business, the loans in question would still not be proximately related to that business.\textsuperscript{15}

\textsuperscript{11} See I.R.C. 166(d)(2).
\textsuperscript{12} Taxpayer generally used two methods of financing the sale of tract homes, the conditional sales contract and direct sale with financing. 34 T.C.M. (CCH) at 985,986 (1975).
\textsuperscript{13} 375 F.2d 36 (5th Cir. 1967).
\textsuperscript{14} Id. at 41 (emphasis added).
\textsuperscript{15} Even if a taxpayer is engaged in the trade or business of loaning money, it is well established that the particular loan in issue must be “proximately” related to that trade
Having found that Taxpayer had not been involved in a genuine money lending business apart from his land development business, the court then addressed the more critical issue of whether Taxpayer's loans were made in connection with his real estate development business. On this issue Taxpayer contended that his dominant and sole motive, as required by United States v. Generes,16 in advancing loans to his father and SVH was to capitalize on land opportunities his father's corporation had undertaken at Serene Lakes, California, for his own profit. Taxpayer supported his assertion that a joint venture had in fact materialized between Taxpayer and his father by pointing out that the project had the possibility of grossing over six million dollars. The court found this assertion unpersuasive, however, because Taxpayer failed to offer convincing evidence that he expected to share profits as a joint venturer in the project. Citing Hogue v. Commissioner,17 the court reasoned that Taxpayer's "unrelated joint ventures with his father in the past does not, without more, prove one in this case."18

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16. The Supreme Court in United States v. Generes, 405 U.S. 93, 103 (1972) held that the question of whether a bad debt has a "proximate" relation to a taxpayer's trade or business "is that of dominant motivation, and that significant motivation is not sufficient." Under Generes, a taxpayer has the burden of establishing that his dominant (not merely significant) motivation in making the loans was to benefit his trade or business, which in Hunsaker had been determined by the Tax Court to be real estate and land development. The Generes Court stated: "The dominant-motivation standard has the attribute of workability. It provides a guideline of certainty for the trier of fact. The trier may then compare the risk against the potential reward and give proper emphasis to the objective rather than the subjective." Id. at 104. See also Hogue v. Commissioner, 459 F.2d 932, 938 (10th Cir. 1972).
17. 459 F.2d 932, 937-38 (10th Cir. 1972).
18. The Hunsaker court further stated that:

[Taxpayer's] own real estate businesses at the times the loans were made and the losses were sustained remained unaffected by SVH and its activities. [Taxpayer's] own projects could not have profited from any gain or income realized by SVH or resulting from the use of [Taxpayer's] loans that are in issue here. Likewise, his own projects would not have had to share any losses incurred by SVH. In fact, any effects the survival and success of SVH might have had on [Taxpayer] were all
Taxpayer further argued that his real estate business somehow depended on SVH's survival, and that this dependence provided the necessary connection between the loans and his real estate business. This claim was based on *Dorminey v. Commissioner*, a "source of supply case." In *Dorminey*, the taxpayer, who was in the wholesale produce business was having trouble obtaining bananas required for his business. He therefore helped organize, bought stock in, and advanced money to a corporation which in turn promised to supply the taxpayer with all the bananas he required. The *Dorminey* court found that taxpayer's dominant motive in making the loans, which were later uncollectible, was to insure a source of supply of bananas for his produce business, and thus allowed the losses to be treated as business bad debts. However, the *Hunsaker* court determined that the principals of *Dorminey* were inapplicable to Taxpayer. Although Taxpayer and his father were both in the business of land development, Taxpayer failed to establish that his real estate business depended on the survival of SVH, even though he claimed he anticipated sharing in the future profits of the corporation. The fact remained that Taxpayer failed to show any profit sharing relationship between SVH and his father. Furthermore, citing *Lundgren v. Commissioner*, the court noted that unlike in the source of supply cases, the anticipated benefits to Taxpayer's trade or business were not real and direct as a matter of law.

Finally, the Ninth Circuit addressed Taxpayer's contention that the Tax Court erred as a matter of law in rejecting his unrelated to his real estate business: the repayment of his loans plus eight percent interest, filial satisfaction from the protection of his father's investment, and the expectation of future benefits either from future business with his father, or from general enhancement of his father's estate.

615 F.2d at 1257. See also United States v. Henderson, 375 F.2d 36, 41-42 (5th Cir. 1967).


20. 376 F.2d 623, 629 (9th Cir. 1967). In *Lundgren*, the taxpayer, in an attempt to expand into a new area, made advances to a newly-formed timber business in South Dakota. The court held that the anticipated benefits to the taxpayer's already existing timber business, which expansion into a new area was expected to bring, was real and direct.

21. The *Hunsaker* court noted that even the speculative benefits Taxpayer contemplated "would have been personal" and "not related to his trade or business." 615 F.2d at 1257.
contradicted and unimpeached testimony that his dominant motive in making the loans was to profit his land development company.22

The court acknowledged that under Imbesi v. Commissioner,23 the Tax Court may have had a duty to consider Taxpayer's testimony even though it may be self-serving. However, it could also consider objective circumstances surrounding the loans in issue.24 The court found that the circumstances surrounding the loans supported the inference drawn by the Tax Court, although the Tax Court's holding was inconsistent with Taxpayer's testimony that his dominant motive was to aid his father's ailing corporation. Hence, "the Tax Court was not required to believe taxpayer."

The court went on to say that the objective facts relied on by the Tax Court in determining Taxpayer's dominant motive in

22. On this issue Taxpayer relied principally on Foran v. Commissioner, 165 F.2d 705 (5th Cir. 1948) and Ross v. Commissioner, 227 F.2d 265 (5th Cir. 1955). In Foran the court of appeals stated:

His testimony is consistent with every proven fact. He gives a credible reason why it was not for sale and why finally in 1941 he did sell it. We think the court's refusal to follow the sworn testimony is contrary to law, and requires the setting aside of its fact-finding as it would that of a jury.

Id. at 706. However, the Foran court further stated: "We recognize that intent may be proved by circumstances, and that a party's testimony as to his intent may be rebutted by proof of circumstances which are inconsistent therewith." Id. at 707.

23. 361 F.2d 640, 644-45 (3d Cir. 1966). The Imbesi court remanded the case because it found that the taxpayer's testimony was not credited. The court stated that:

the primary intent or motive of the taxpayer has always been the ultimate test for determining whether losses are deductible because incurred in a trade or business or in transactions for profit, or on the other hand are not deductible because they are personal expenses . . . . A taxpayer's direct testimony that profit making was his primary purpose, although it suffers from the heavy burden of being self-serving, is not to be put aside without consideration simply because there exists other evidence of some objective circumstances. The evidence must be considered and evaluated as a whole.

24. United States v. Generes, 405 U.S. 93, 104 (1972) ("[the trier of fact must] give proper emphasis to the objective rather than the subjective"). See also, Road Materials Inc. v. Commissioner, 407 F.2d 1121, 1124 (4th Cir. 1969) ("intention to create a debt cannot be so readily proved . . . . Generally it depends upon whether contemporaneous facts, not testimony given years later, establish an unconditional obligation to repay advances."). The Road Materials court affirmed a determination by the Tax Court that advances made to the taxpayer's wholly-owned corporation were contributions to capital even though the advances were shown as loans on the taxpayer's books.
making the loans could be framed in terms of the "risk v. potential reward" analysis put forth in *Generes*. The facts that SVH was seriously undercapitalized at the time Taxpayer made the loans and that Taxpayer required no security for these loans was strong evidence that the big profits Taxpayer anticipated were mere expectations of future benefits, thus negating a dominant business motive. The court also noted that Taxpayer's father, who had over three and a half million dollars invested in SVH, would have shown some gratitude if the corporation had prospered. However, the fact remained that the benefits were contingent on the success of SVH. Based on these facts the court held that the inference drawn by the Tax Court that Taxpayer's dominant motive was to aid his father and his father's ailing corporation was not erroneous and thus binding.25

*The Government's Cross-Appeal*

The government's cross-appeal raised the issue of whether the Tax Court erred in holding that payments made by Taxpayer as guarantor on the performance bonds were deductible under section 166(f) of the Code. Section 166(f) provides a limited exception to the general rule of section 166(d) that a noncorporate taxpayer must treat a nonbusiness bad debt as a short term capital loss.26

The court in *Hunsaker*, determined that Taxpayer would be entitled to a business bad debt deduction under section 166(f) if all the following requirements had been met: (1) the guarantor, endorser, or indemnitor making payment (Taxpayer) was not a corporation; (2) the borrower (Patty and Taxpayer's father) was not a corporation; (3) the proceeds of the original obligation were used in the trade or business of the borrower; and (4) the obligation of the borrower to the creditor (county and General Insurance Company) was worthless at the time of payment, without regard to the guaranty.


26. For taxable years beginning in 1976, and thereafter, the status of guarantee obligations will be determined in accordance with the following rule as prepared by the staff of the Joint Committee on Taxation, H.R. Rep. No. 1861, 94th Cong., 2d Sess. 157 (1976). Where a taxpayer has a loss arising from the satisfaction of a guarantee, he will receive the same tax treatment as when he has a loss from a direct loan. The underlying rationale apparently is that the giving of a guarantee is but an indirect method of financing. Gillespie v. Commissioner, 54 T.C. 1025 (1970).
The court determined that there was no dispute as to the first two requirements having been met, and declined to consider, the third requirement because it had not been in issue before the Tax Court. The court then focused its attention on the fourth requirement under section 166(f)—that the obligation of the borrower to the creditor be worthless at the time of payment, without regard to the guaranty.27

The Tax Court had failed to determine whether the obligation of Patty as principal on the bond was worthless to the creditor, General Insurance Company. The court reasoned that the only principal in essence was Taxpayer’s father, due to Taxpayer’s hold harmless agreement with Patty and the fact that Patty was principal in name only to comply with local law.

However, the Ninth Circuit determined that Patty’s reason for signing the bonds, and his freedom from ultimate liability due to Taxpayer’s hold harmless agreement, did “not justify ignoring, for purposes of section 166(f), the fact that Patty was legally bound to the County Water District as principal on the obligation.”28 Furthermore, the fact that ultimate liability would fall on Taxpayer due to his own hold harmless agreement with Patty “does not make worthless the obligation which is the focus of . . . section 166(f).” Moreover, “[s]ection 166(f) does not permit [t]axpayer to recoup via favorable tax status any extra losses he incurred as a result of a collateral agreement he made with Patty after the bonds and guaranty were signed.” The court further pointed out that even indemnitors who never had a right to reimbursement against the principal debtors, “must show the worthlessness of the original obligation in order to benefit from section 166(f).”

27. See Andrew v. Commissioner, 54 T.C. 239, 247 (1970), which stated the general rule relied on by the Ninth Circuit court in Hunsaker that § 166(f) of the Code requires that the original obligation between the principal and the creditor be worthless, rather than the guarantor’s or indemnitor’s claim against the principal obligor.

28. The Hunsaker court further reasoned that “[t]he local governments had good reason to require the land title-owner to be on the bonds, if for no other reason than to reach the land, if necessary, to satisfy any unmet liability. Thus the creditors could have looked to Patty for repayment.” 615 F.2d at 1259. It is unclear whether the court would still have required Taxpayer to show the worthlessness of Patty’s obligation to the creditor if it were determined that Patty signed the bond merely as a formality.
The court then distinguished *Andrew v. Commissioner*, which had held for the taxpayer. In *Andrew*, the taxpayer was allowed section 166(f) deductibility by showing that the creditors' claims against the principal debtors were worthless, despite the fact that the surety, whom the taxpayer agreed to indemnify, had not been first called upon to pay the creditors. The Tax Court stated its rationale in *Andrew* as follows: "By paying the customers directly, [taxpayer] merely telescoped the transaction, and thereby avoided additional expenditures . . . that would have arisen had the surety first been called upon to liquidate the customers' claims." However, the court in *Hunsaker* reasoned that Taxpayer had not attempted to "telescope" anything, but had attempted to avoid the stringent requirements of section 166(f), and in effect nullify the distinction between a surety and principal debtor, because there had been no showing of Patty's insolvency.

Finding that the Tax Court had erred in ignoring Patty's status as principal on the bonds, the court reversed the decision, permitting section 166(f) deductibility of Taxpayer's payments as guarantor. The court also remanded the case to provide Taxpayer an opportunity to show, if possible, that Patty's obligation was worthless at the time of payment. If this is not shown, Taxpayer's loss will be entitled to only short-term capital loss treatment as a nonbusiness debt under section 166(d).

D. ANALYSIS OF THE COURT’S REASONING IN DENYING THE TAXPAYER BUSINESS BAD DEBT LOSS

*Inference that Intrafamily Loans are Nonbusiness Bad Debts*

In analyzing the court's reasons for denying Taxpayer a business bad debt loss under section 166(a)(1) of the Code, it is important to note the strong inference that intrafamily loans are nonbusiness debts. Therefore, uncollectable intrafamily loans

30. Id. at 247.
31. If a taxpayer's motive is to help a member of his family, there is a strong inference that the debt is a nonbusiness debt. *Estate of Broadhead v. Commissioner*, 391 F.2d 841 (5th Cir. 1968); *Goldman v. Commissioner*, 21 T.C.M. (CCH) 181 (1962); *Mercil v. Commissioner*, 24 T.C. 1150 (1955); *Clark v. Commissioner*, 18 T.C. 780 (1952). In *Rude v. Commissioner*, 48 T.C. 165 (1967) the Tax Court intimated a presumption that a transaction between related parties is a gift. In *Whipple v. Commissioner*, 373 U.S. 195, 201 (1963) the Supreme Court stated that the leading case of *Putnam v. Commissioner*, 3
are either deductible as nonbusiness bad debts under section 166(d) of the Code, or not at all when the parties are found to have contemplated a gift transaction.

The Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1976 stated the following as to intra-family loans:

Generally, in the case of a direct loan, the transaction is entered into for profit by the lender, who hopes to realize interest on the loan. However, this may not be true in the case of loans made between friends or family members, and in these cases the Internal Revenue Service will generally treat any loss resulting from such a "loan" as a gift, with respect to which no bad debt deduction is available.32

Section 166(1)(a) of the Code is not rendered inapplicable, however, because a taxpayer lends money to a member of his or her family.33 In order for a taxpayer to overcome the strong inference of a gift, the taxpayer must successfully demonstrate that he or she was engaged in a trade or business when the debt was created or acquired and that the losses from the debt bear a direct relation to that trade or business.34 In addition, the Su-


34. Levin v. United States, 597 F.2d 760, 764 (Ct. Cl. 1979); Treas. Reg. § 1.166-5(b)(2) (1985) provides in part:

[T]he question whether a debt is a nonbusiness debt is a question of fact in each particular case . . . For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of
preme Court in United States v. Generes\textsuperscript{35} required that the proximate business relationship provide the dominant motivation for the indebtedness.\textsuperscript{36}

In Hunsaker, Taxpayer claimed business bad debt loss on several theories, but the court found all arguments without merit. Taxpayer failed to establish either a separate lending business, the existence of a joint venture, or the dependence of his business on the success or failure of his father’s corporation. Furthermore, the court held that the objective factors surrounding the transaction—undercapitalization, unsecured debt, and profit contingent on success of borrower’s trade or business—supported the Tax Court’s inference that Taxpayer's dominant motive was to aid his father’s company and not his own.

\textit{Failure of the Taxpayer to Establish A Separate Lending Business}

The taxpayer has the burden of establishing a trade or business.\textsuperscript{37} In determining what constitutes a trade or business, no single factor determinative. However, the activities constituting a trade or business must occupy a subsantial amount of a taxpayer's time.\textsuperscript{38} In \textit{Imel v. Commissioner}, nine loans over a four year period were held insufficient lending activity to establish a genuine money lending business.\textsuperscript{39}

See also Whipple v. Commissioner, 373 U.S. at 200-01 n.9; H.R. Rep. No. 2333, 77th Cong., 2d Sess. 96 (1943).

35. In Generes, 405 U.S. at 104, the Supreme Court reasoned:
By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and however insignificant, from controlling the tax result at the taxpayer's convenience. This is of particular importance in a tax system that is so largely dependent on voluntary compliance.

36. See also Hogue v. Commissioner, 459 F.2d 932, 937 (10th Cir. 1972).
37. Spillers v. Commissioner, 407 F.2d 530 (5th Cir. 1969).
38. Snell v. Commissioner, 97 F.2d 891 (6th Cir. 1938).
39. 61 T.C. 318 (1973). In Jessup v. Commissioner, 77 T.C.M. (P-H) ¶ 77,289 (1977), 31 loan transactions in a 10-year period was held sufficient to establish a lending business. See also United States v. Henderson, 375 F.2d 36 (5th Cir. 1967).
Although Taxpayer was heavily involved in financing arrangements during the years in issue, all of these arrangements were correctly determined to be integral to Taxpayer’s real estate business. Taxpayer never actively sought out a separate lending business, advertised, or maintained a separate office for that purpose. Furthermore, no separate books were kept and Taxpayer failed to produce statements of profits and losses from his loan activities. The fact that Taxpayer had notes receivable did not ipso facto evidence a separate money lending business.

Joint Venture Never Established

A determination of a business bad debt may be based solely on anticipated success of a joint venture, even though such anticipation flows from an excess of confidence. However, the creation of a joint venture must still be adequately supported by evidence, and all factors must be considered. "It is well established that there are four basic attributes which are indicative of a joint venture: (1) a contract, expressed or implied, that a joint venture be formed; (2) the contribution of money, property and/or services by the venturers; (3) an agreement for joint proprietorship and control; and (4) an agreement to share profits."

The Tax Court noted that there may have been discussions between Taxpayer and his father to form a joint venture, however, the fact remains that no venture actually materialized. Preliminary discussions of a joint venture are not sufficient evidence to establish its existence. Taxpayer failed to offer evidence of decisions relating to capital contributions, the sharing of profits and losses, and decisions as to joint proprietorship and control. Although Taxpayer had a history of forming partnerships and

40. Down v. United States, 328 F.2d 314 (9th Cir. 1962).
41. The burden of showing a joint venture is upon the taxpayer asserting its existence as a basis for deduction of losses incurred. Perlmutter v. Commissioner, 373 F.2d 45 (10th Cir. 1967). Note that I.R.C. §§ 761(a), 7701(a)(2) define “partnership” as including joint ventures. For a treatment of the family partnership problem, see Commissioner v. Culbertson, 337 U.S. 733 (1949); Beck v. Chemical Equip. Corp., 27 T.C. 840 (1957).
other ventures with his father, he offered no independent evidence aside from his oral testimony that a joint venture had in fact been established in this case.

Source of Supply

Taxpayer also failed to establish that his real estate business depended on the success or failure of his father's corporation. A comparison of two cases which allowed bad debt deductions based on a “source of supply” theory indicate that Taxpayer failed to establish any such relationship between insuring development projects for his own business, and the success of his father's corporation. In Garlove v. Commissioner, the Tax Court allowed a business bad debt deduction where the taxpayer, a lawyer, loaned funds to a client to allow the client to stay in business. The funds were later uncollectible. The Tax Court reasoned that the business basis for the loans was evidenced by the substantial fees the taxpayer received from his client. Thus, the benefits to the taxpayer's business stemming from these loans were found to be real and direct. In Estate of Saperstain v. Commissioner, the Tax Court also allowed a taxpayer a business bad debt deduction based on “source of supply.” The taxpayer in Saperstain, a sports promoter and owner of the Harlem Globetrotters, made advances to a newly created professional basketball league. The proximate business basis for these loans was found to be that the new league would provide teams to compete with the Globetrotters.

Unlike the above cases, the anticipated benefits contemplated by Taxpayer as a result of his relationship with his father were merely speculative. Taxpayer had failed to establish a profit sharing relationship with his father. The only return promised to Taxpayer was eight percent interest on the notes, which could hardly establish a case for the dependence of Taxpayer's business on his father's, based on a “source of supply theory.”

44. 65 T.C.M. (P-H) ¶ 65,201 (1965).
45. 29 T.C.M. (CCH) ¶ 916 (1970).
46. See also Hogue v. Commissioner, 459 F.2d 932 (10th Cir. 1972) (taxpayer, an accountant, unable to show relationship of loans to obtain new clients); Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955).
Contemporaneous Factors vs. Subjective Intent

Taxpayer correctly contended that his self-serving testimony was entitled to be considered. Yet a court may look at all objective factors surrounding the transaction, and ultimately, the objective factors take precedence in determining the dominant motivation of a taxpayer at the time of the transaction. Moreover, in the recent case of Levin v. United States, the court stated: “Clearly the standard is to be objective and not subjective. To this end, Generes specifically warns that self-serving statements alone will not suffice to prove a taxpayer’s business purpose in advancing money.”

In Levin, the taxpayer’s self-serving testimony was properly discounted. The taxpayer claimed that religious reasons precluded him from charging interest, but objective facts tended to prove that he did not treat the advances in a businesslike manner. He waited three years after the statute of limitations ran before he enforced the debt, claiming he did not need the money until then.

An examination of the objective factors surrounding the Hunsaker transaction are indicative that the court reached the correct result in upholding the Tax Court’s inference that Taxpayer’s dominant motive was to aid his father’s corporation. Taxpayer’s transaction was overshadowed by objective factors: undercapitalization of his father’s corporation, severe cash flow difficulties, security for indebtedness not required, and profit contingent on success. Although the court did not specifically state that any one factor alone was controlling, the presence of two or more of these factors in a given transaction between friends or related parties may certainly be sufficient to negate a taxpayer’s sworn testimony to the contrary.

Unsecured Debt

Perhaps the must critical factor considered by the court in

47. In characterizing a business bad debt, objective factors along with evidence of intent must be considered. Casco Bank & Trust Co. v. United States, 544 F.2d 528 (1st Cir. 1976). See also Imbesi v. Commissioner, 361 F.2d 640 (3d Cir. 1966).
48. Harshy v. United States, 590 F.2d 884 (10th Cir. 1979). See also Smith v. Commissioner, 370 F.2d 178 (6th Cir. 1966) (objective contemporaneous criteria must be considered and accorded great weight).
49. Levin v. United States, 597 F.2d at 766.
denying Taxpayer business bad debt loss was the fact that Taxpayer failed to secure the obligation. The fact that a party has sought to protect his creditor status by obtaining security strongly enhances the possibility that its advances will be considered a business debt. As a practical matter, loans between family members should always be evidenced by security. Hunsaker indicates that interest alone may not be sufficient. The court specifically stated that even if the Tax Court had been willing to assume a separate lending business, the loans advanced to Taxpayer’s father would still not be proximately related to that business primarily because of the absence of security for these advances.

Had Taxpayer realistically secured the debt by requiring real estate or land options from his father, a more compelling argument could have been made that Taxpayer acted purely out of an economic desire to profit in his own land business.

**Undercapitalization—Negative Cash Flow**

Thin capitalization of Taxpayer’s father’s corporation was also found to be a critical element in discounting Taxpayer’s testimony that he acted out of a pure profit motive. Taxpayer extended large sums of money to his father’s corporation, which was severely undercapitalized and continually experienced cash flow shortages. The inference to be drawn here is that prudent, profit-oriented lenders do not in the ordinary course of their business make loans to risky businesses without requiring security. Although “thin capitalization of a corporation to which [a] taxpayer makes an advance, will not alone justify the indebtedness as a nonbusiness debt, it is very strong evidence.”

Here, it is important to note the overlapping significance between cases involving loans made to family and friends, and cases involving the issue of whether advances by a stockholder to a closely held corporation are to be considered debts or contributions to capital. The *Hunsaker* court expressly stated that the distinction between these two types of cases amounts to little difference when “[o]ther motives might well be involved in

51. 615 F.2d at 1256 n.2.
52. Curry v. United States, 396 F.2d 630, 634 (5th Cir. 1968).
any given case, such as personal desire to aid friend or family through tough times.53

In United States v. Henderson,54 a case factually similar to Hunsaker, the taxpayer was a shareholder in her grandson-in-law's closely held corporation, and advanced large sums of money at a time when her grandson-in-law's foundry corporation was operating at a loss. Despite the fact that the corporation continued to lose money, she continued to make large advances. Moreover, the taxpayer did not require security for these advances, and repayment was expected only when and if the corporation showed a profit. Consequently, Henderson was denied a bad debt loss, and her advancements were properly treated as capital investments.55

Thus, in Hunsaker, the fact that SVH was seriously undercapitalized at the time Taxpayer extended large sums of money without requiring security as he customarily did in his real estate business, cut sharply against Taxpayer.

Further Considerations

If repayment of an advance by a taxpayer is contingent on the success of the borrower's trade or business, the advancement is generally treated as a nonbusiness debt.56 In Rolwing-Moxley Co. v. United States,57 the Eighth Circuit denied the taxpayer a bad debt loss deduction where it was found that repayment was predicated on the borrower's financial success, and the debt was unsecured.

53. 615 F.2d at 1256 n.3.
54. 375 F.2d 36 (5th Cir. 1967).
55. I.R.C. § 165(g) provides:
   (g) Worthless Securities.—
   (1) General rule.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.
   (2) Security defined.—For purposes of this subsection, the term "security" means—
      (A) a share of stock in a corporation.
56. In re Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); see also Diamond Bros. Co. v. Commissioner, 322 F.2d 725 (3d Cir. 1963).
57. 589 F.2d 353 (8th Cir. 1978).
Although not stated in the *Hunsaker* opinion, a further consideration is the likelihood of an independent lender advancing money to a particular debtor in question. In *Transamerica Insurance Co. v. Woamack*, the Tax Court considered the extreme unlikelihood of an independent lender lending under similar circumstances, and denied the taxpayer a bad debt loss. Likewise, in *Hunsaker*, it appears extremely unlikely that Taxpayer's father could have procured similar unsecured loans from an independent lending institution, in light of the severe undercapitalization and cash flow difficulties of his corporation.

**Significance**

Because it is the policy of the courts to scrutinize intrafamily loans in great detail, tax practitioners should determine if the loan is evidenced by a note that is realistically secured and backed by proof that the borrower is solvent, that repayment is expected and not contingent on the success of the borrower's trade or business, and that an independent lender would be likely to lend under similar circumstances. Absence of one or more of these factors in a family context is likely to lead to nonbusiness bad debt treatment under section 166(d) of the Code, and may even justify a court in finding that the parties intended a gift, for which no deduction will be allowed.

With respect to Taxpayer's payments as guarantor, the court's analysis was straightforward. There were two joint principals on the bonds which Taxpayer had agreed to guarantee. The Tax Court correctly found that Taxpayer's father's obligation was worthless as required by 166(f) of the Code, but failed


59. See Hetherington v. Commissioner, 20 B.T.A. 806 (1930); Levitz v. Commissioner, 52 T.C.M. (P-H) ¶ 52,268 (1968). See also Redeldheimer v. Commissioner, 64 T.C.M. (P-H) ¶ 64,060 (1964) (repayment not expected nor intended, therefore parties contemplated a gift).

60. See I.R.C. § 166(f); Treas. Reg. § 1.166-6 (1957). I.R.C. § 166(f) provides a limited exception to the general rule of Putnam v. Commissioner, 352 U.S. 82 (1965) that losses incurred on guarantee agreements prior to 1976 are deductible from ordinary income only if the guarantee was related to taxpayer's trade or business. Therefore under I.R.C. § 166(f) a noncorporate guarantor or indemnitor of a noncorporate obligation which is issued in furtherance of the borrower's trade or business may be treated as a business debt without regard to the business versus nonbusiness analysis.
to make this determination as to the second principal, Patty, reasoning that he was merely a straw man in the transaction for the purpose of complying with local law. The Ninth Circuit properly rejected Taxpayer's reasoning, finding that the local governments "had good reason" to require the titleholder's signature on the bonds, "if for no other reason than to reach the land . . . to satisfy any unmet liability." 61

It is well established that section 166(f) deductibility is triggered by the worthlessness of the principal debt, and no deduction can be taken unless the principal debt is in fact worthless. 62 In Horne v. Commissioner, 63 the Ninth Circuit denied a taxpayer, as indemnitor, section 166(f) deductibility for failure to show that the underlying obligation of the borrower to the creditor was in fact worthless.

Furthermore, legislative history of section 166(f) provides:

This subsection will allow a deduction from a gross income for a loss suffered by a noncorporate taxpayer through payment during the taxable year of part or all of his obligation as guarantor, endorser, or indemnitor of a noncorporate obligation. In order to obtain an ordinary loss, the taxpayer must establish that the proceeds were used in the trade or business of the borrower and that the obligation of the borrower, to whom the taxpayer made payment in discharge of his guarantor's obligation, was worthless at the time of payment (without regard to the guaranty, endorsement, or indemnity). 64

Thus, for guarantee, endorsement, and indemnity agreements entered into before 1976, 65 a taxpayer is required to show

61. 615 F.2d at 1259.
63. 523 F.2d 1363 (9th Cir. 1975).
65. In the case of noncorporate guarantor, endorser, or indemnitor agreements entered into after 1975, the following rules apply:
   (1) A worthless debt will qualify as a business bad debt if it is established that the dominant motive for guaranteeing the debt was proximately related to the guarantor's trade or
the worthlessness of the original obligation between the principal and creditor before an ordinary loss can be taken. Moreover, where a taxpayer is guarantor for an obligation involving two or more principals, he must be prepared to show the worthlessness of all of the above obligations so long as there is some reasonable basis requiring each of these principals to be part of the transaction.

E. Conclusion

In Hunsaker, Taxpayer claimed a business bad debt loss on several creative theories. However, the Ninth Circuit properly held, based on the lack of evidence and objective factors surrounding the transaction, that Taxpayer was not entitled to business loss under section 166(1)(a) of the Code. Furthermore, with respect to payments made by Taxpayer as guarantor, the court also reached the proper result in requiring him to establish the worthlessness of the other principal’s obligation to the creditor since that principal was a vital party to the transaction.

Robert Michael Fanucci*

IV. OTHER DEVELOPMENTS IN TAXATION

In Redwood Empire Savings and Loan Assoc. v. Commissioner, 628 F.2d 516 (9th Cir. 1980), the taxpayer purchased

(2) A worthless debt will qualify as a nonbusiness bad debt if it is established that the guaranty transaction was entered into for profit but not as part of the guarantor's trade or business.

(3) If the guarantor has a right of subrogation or other similar right against the maker (debtor), no bad debt deduction will be allowed until the year in which the right against the maker becomes worthless. If the guarantor has no right against the maker, the payment under the guaranty agreement is deductible for the year in which the payment is made.

(4) If the guaranty agreement was entered into without consideration as an accommodation to a friend or relative, no deduction loss will be allowed.

STAND. FED. TAX REP. (CCH) Bad Debts ¶ 1631 (1980).

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Malibu Springs Ranch in 1967 for $750,000 and sold it in 1972 for $277,539. During this time, the taxpayer paid legal fees for what the Tax Court held was a lawsuit to defend or protect title to the property, and not to defend a charge of fraud by the Malibu Springs seller as the taxpayer claimed. The taxpayer settled the suit in 1972 for $300,000, and treated the loss on the sale and the expenses in defending and settling the lawsuit as deductible ordinary business expenses. The Commissioner denied such treatment.

The taxpayer had argued that the Malibu Springs property was held “primarily for sale to customers in the ordinary course of [its] trade or business,” I.R.C. § 1221(1), or alternatively, that the purchase and sale of the property was an integral part of its business of making loans, and therefore subject to ordinary loss treatment under the Corn Products doctrine, 350 U.S. 46 (1955). Because the taxpayer recorded its purchase of the property pursuant to section 6705 of the California Financial Code, which authorizes savings and loan associations to invest in specific kinds of residential property in order to assist in the generation of loans, the taxpayer argued that the property was necessarily held primarily for sale to customers in the ordinary course of the business of making loans.

The Ninth Circuit held that even if the taxpayer did acquire or develop the property for the purposes authorized by the statute, which it had not, such purpose would not be determinative of whether the property was held primarily for sale to customers. The court held that the taxpayer’s actual purpose for acquiring, holding, and selling the property controlled in determining whether the property was held primarily for sale to customers in the ordinary course of business. Finding the Tax Court’s determination that the taxpayer acquired Malibu Springs as part of a scheme to defraud the prior owners of the property not to be clearly erroneous, and finding that the taxpayer at no time considered developing the property for the purpose of generating loans, the Ninth Circuit held that the taxpayer did not meet the test. The loss could therefore not qualify as an ordinary business loss because the property was a capital asset. In addition, because the loan factor involved in the sale of the property was an incidental and not an integral part of the taxpayer’s business of making loans, the Ninth Circuit found no factual basis for the application of the Corn Products doctrine.

In addressing the taxpayer’s claim to deduction of legal fees
and settlement costs, the court of appeals rejected the taxpayer's disguised "dominant purpose" test. The court stated that as a general rule, legal expenses incurred in defending against a claim of fraud that would injure or destroy a business have been held to be ordinary and necessary business expenses. However, legal expenses and settlement payments which are incurred to protect or defend title are non-deductible capital expenditures. As a test to determine whether legal fees and settlement expenses in a case such as this are deductible, the Ninth Circuit held that one must examine the original and nature of the claim, rather than the taxpayer's dominant purpose in defending the lawsuit. In agreeing with the Tax Court's finding that the lawsuit originated in the transactions by which the taxpayer acquired Malibu Springs and that the fraud claim challenged the validity of the taxpayer's title to the property, the court held the purpose of the defense and settlement was to defend and protect title. Therefore, the legal expenses and settlement costs were capital outlays pursuant to section 162(a) and were not deductible business expenses.

In *Dwyer v. United States*, 606 F.2d 460 (9th Cir. 1980), the federal government appealed from a district court decision that the taxpayers were entitled to a refund for federal income taxes collected for the tax year 1968. The issues before the court involved tax consequences stemming from the liquidation of a corporation by the taxpayer and his son, and in particular, the effect of the taxpayer's forgiveness of interest on debts owed him by the corporation. The court of appeals held that the taxpayer had realized ordinary income where the interest forgiveness took place simultaneously with the liquidation of the corporation.

In March 1966, the taxpayer and his son each invested $50,000 and formed a corporation. As the corporation needed more operating capital, the taxpayer contributed additional funds on an "open account" in exchange for five year debentures, each bearing a five percent rate of interest. The corporation, an accrual method taxpayer, recorded the interest on the loans as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1966</td>
<td>$5,000.00</td>
</tr>
<tr>
<td>December 31, 1967</td>
<td>$16,041.66</td>
</tr>
<tr>
<td>December 31, 1968</td>
<td>$17,833.37</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$35,875.03</strong></td>
</tr>
</tbody>
</table>
Late in 1968, the corporation entered into an agreement with a purchaser which called for the sale of the corporation's major assets, followed immediately by liquidation. The liquidation and sale took place simultaneously on December 30, 1968. On that date, the corporation owed the taxpayer the following amounts:

<table>
<thead>
<tr>
<th>Debentures</th>
<th>$400,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open Account</td>
<td>$170,000.00</td>
</tr>
<tr>
<td>Interest</td>
<td>$38,875.03</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$608,875.03</strong></td>
</tr>
</tbody>
</table>

Also on December 30, 1968 the following events took place: 1) the corporation sold its assets for $700,000; 2) the corporation paid the taxpayer the $400,000 due on the outstanding debentures; 3) the corporation paid the taxpayer $170,000 in payment of the "open account"; 4) the taxpayer and his wife forgave the $38,875.03 interest owed in a document entitled "Forgiveness of Indebtedness"; and 5) the corporation retired its common stock in complete liquidation by paying $65,000 to the taxpayer and his son.

The sole issue before the court of appeals was the personal income tax consequences to the taxpayer as a result of the liquidation of the corporation. The court found that in the absence of the purported interest forgiveness, the taxpayer would have realized additional ordinary income of $38,875.03. Clearly, the corporation owed the taxpayer a legitimate debt, and had the money to pay the debt as it distributed the proceeds of the liquidation. Primarily because the taxpayer exercised significant control over the corporation, the court of appeals held that the taxpayer received ordinary income under the doctrine associated with the Supreme Court's decision in *Helvering v. Horst*, 311 U.S. 112 (1940). See *Lucas v. Earl*, 281 U.S. 111 (1930). The forgiveness of interest in order to change the characterization of the assets was analogous to an anticipatory assignment of income and therefore invalid.

The taxpayer did not directly challenge the applicability of *Helvering*, however. He claimed that because the corporation was unable to doubt the interest accrued during 1966 and 1967 (it did not meet the requirements of section 267(a)(2), it would be unfair to disregard his purported forgiveness and require the recognition of ordinary income, while the corporation was unable to take the normal deduction. *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976). In *Putoma* the shareholders forgive an in-
debtedness. However, there was no immediate liquidation of the corporation and receipt of the assets by the shareholders. The forgiveness was for bona fide business purposes, and the shareholders had no control over the disposition of the proceeds. Thus, due to the control the taxpayer in Dwyer had over the corporation, and the simultaneous liquidation of the corporation and the forgiveness of the indebtedness, Putoma was inapposite. The taxpayer was held to have realized ordinary income.

In United States v. Carlson, 617 F.2d 518 (9th Cir. 1980), a case of first impression, the Ninth Circuit resolved the question of whether the privilege against self-incrimination may be maintained in an action for wilful failure to file an income tax return under 26 U.S.C. § 7203 (1970). In Carlson, the taxpayer claimed ninety-nine withholding exemptions on his W-4 form, although he was not married and had no dependants. He refused to disclose the nature of these exceptions, claiming that such disclosure might lead to criminal liability for having filed false withholding forms.

The district judge found that the taxpayer “did not have a good faith claim or reasonable ground for [asserting the] privilege . . . .” Thus, the taxpayer’s claim was held not to constitute a defense to a section 7023 violation.

In Garner v. United States, 424 U.S. 648, 662 (1976), the Court determined that “[a] section 7203 conviction cannot be based on a valid exercise of the privilege.” However, the Garner holding was specifically limited to “only those [claims of the privilege against self-incrimination] justified by fear of self-incrimination other than under the tax laws.”

After considering the history and purposes of the privilege and the need for revenues, the court concluded that the taxpayer “attempted to take advantage of the privilege’s protective capacity to further a calculated effort to avoid the payment of taxes.”

The court further held that the taxpayer’s failure to assert his claim in good faith constituted wilful misconduct, and he was therefore subject to the sanctions of section 7203 for willfully failing to file an income tax return.