

# TAX CASES OF THE FEDERAL CIRCUIT IN 1994

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## INTRODUCTION

During its 1994 term, the Federal Circuit considered a variety of tax issues, including the taxability of punitive damage awards under section 104(a)(2),<sup>1</sup> the tax treatment of tort liability settlement fund contributions,<sup>2</sup> the validity of a U.S.-Puerto Rico withholding agree-

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1. See *Reese v. United States*, 24 F.3d 228, 230 (Fed. Cir. 1994) (examining statutory language of I.R.C. § 104(a)(2), which excludes compensation for injuries and sickness from income, to determine whether punitive damages received on account of personal injuries are excludable).

2. See *Maxus Energy Corp. v. United States*, 31 F.3d 1135, 1142-45 (Fed. Cir. 1994) (using "all events" test to determine whether taxpayer is entitled to current deduction).

ment for federal wages,<sup>3</sup> and the taxability of a federal judge's disability retirement payments.<sup>4</sup> This Article reviews and discusses those decisions with a view toward their overall importance and precedential impact. Although the Federal Circuit, as a refund jurisdiction, hears far fewer tax cases in a term than does the United States Tax Court, the cases it hears are often of particular significance, import, and dollar value. This certainly proved true in 1994.

## I. TAX SHELTERS

The Federal Circuit heard two tax shelter cases in 1994, far fewer than in prior years. The first case, *Transpac Drilling Venture v. United States*,<sup>5</sup> discussed who may serve as a tax matters partner under § 6231(a)(7).<sup>6</sup> The second case, *Mulholland v. United States*,<sup>7</sup> discussed use of the Rule of 78's accounting method in computing interest deductions. The Federal Circuit decided both cases for the Government.

Transpac Drilling Ventures (TDVs) was a series of seventy-three tax shelter limited partnerships formed to acquire interests in oil and gas properties.<sup>8</sup> The Government began a civil audit of some of the partnerships in 1983 and then extended its examination to criminal investigations in 1985, 1986, and 1987.<sup>9</sup> Douglas Adams was a tax matters partner (TMP) for many of the TDV partnerships.<sup>10</sup> In 1987 Adams pled guilty to criminal tax charges arising from his promotion-

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3. See *Romero v. United States*, 38 F.3d 1204, 1207-12 (Fed. Cir. 1994) (determining validity of U.S.-Puerto Rico agreement withholding income tax from federal employees).

4. See *Kane v. United States*, 43 F.3d 1446, 1448 (Fed. Cir. 1994) (considering whether disability retirement payments received by judges under 28 U.S.C. § 372(a) are excludable from gross income under § 104(a)(2)).

5. 16 F.3d 383 (Fed. Cir.), cert. denied, 115 S. Ct. 79 (1994).

6. See I.R.C. § 6231(a)(7) (1988) (defining tax matters partners as (a) general partners designated as tax matters partners as provided in regulations, or (b) if no partners are so designated, general partners with largest profits in partnership at close of taxable year). Note that all section references are to the Internal Revenue Code of 1986, unless otherwise noted. The I.R.C. may be found at 26 U.S.C.

7. 22 F.3d 1105 (Fed. Cir. 1994).

8. See *Transpac Drilling Venture v. United States*, 67 Tax Ct. Mem. Dec. (CCH) 1994-26 (Jan. 24, 1994) (relating history of TDV's formation).

9. See *Transpac Drilling Venture v. United States*, 16 F.3d 383, 385 (Fed. Cir.), cert. denied, 115 S. Ct. 79 (1994). Under the statutory scheme created by the Tax Equity and Fiscal Responsibility Act of 1982, I.R.C. §§ 6221-6233 (1988), audits of partnerships are conducted (other than for certain small partnerships) at the partnership level. See *id.* § 6221 (describing tax treatment of partnerships); *id.* § 6231(1)(B) (excluding partnerships of 10 or fewer partners from definition of partnership under § 6221).

10. *Transpac*, 16 F.3d at 385. Partnerships must designate a tax matters partner who is responsible for overseeing an audit and keeping all partners notified of its progress. I.R.C. § 6223(g) (1988).

al activities with respect to various TDV partnerships.<sup>11</sup> Notwithstanding Adams' plea, the IRS, which was not a party to the plea arrangements, continued to treat Adams as the TMP, and in this capacity, the IRS sent copies of Final Partnership Administrative Adjustments (FPAAs) for several of the partnerships to Adams in 1989.<sup>12</sup>

Adams resigned as TMP from all of the TDV partnerships in January 1990, without filing a petition for readjustment of any FPAAs in any court.<sup>13</sup> In his statement of resignation, Adams appointed three limited partners as general partners "for the limited purpose of serving as TMP" for the involved TDV partnerships.<sup>14</sup> A majority of the limited partners in the partnerships subsequently ratified these appointments.<sup>15</sup> A designated limited partner of each partnership filed a readjustment petition in the Court of Federal Claims (Claims Court) in February 1990, which was within the ninety-day period following issuance of the FPAAs.<sup>16</sup> After the ninety-day period expired, other limited partners filed timely petitions in the United States Tax Court.<sup>17</sup>

The Government moved to dismiss the actions in the Claims Court for lack of jurisdiction, arguing that a petition to review a FPAAs must be filed by a TMP within the ninety-day period following its issue, and none of the limited partners was a TMP.<sup>18</sup> The Claims Court granted the motion to dismiss.<sup>19</sup>

In *Transpac Drilling Venture v. United States*,<sup>20</sup> the Federal Circuit upheld the Claims Court's dismissal.<sup>21</sup> The court explained that limited partners cannot be TMPs under §§ 6231(a)(7)(A) and (B),

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11. See *Transpac*, 16 F.3d at 385 (stating that Adams pled guilty to conspiracy and aiding and abetting investment counselor fraud).

12. See *id.* (concluding that because IRS was not party to plea agreement, it was free to pursue any lawful claims against Adams).

13. *Id.* If the IRS believes adjustments are appropriate at the conclusion of an audit, it will issue an FPAAs to the TMP and all partners who are entitled to notice under § 6223(a). I.R.C. § 6223(d)(2) (1988). The TMP then has 90 days to file a petition challenging the FPAAs in the Tax Court, Court of Federal Claims or appropriate District Court. *Id.* § 6223(a). If the TMP does not file within 90 days, any notice partner can file a readjustment petition within the next 60 days in any one of these courts. *Id.* § 6223(b)(1).

14. *Transpac*, 16 F.3d at 386.

15. *Id.* (noting that partners accepted appointments on April 9, 1990).

16. *Id.*

17. *Id.* Rules determine jurisdictional priority if more than one petition is filed. I.R.C. §§ 6223(b)(2)-(4) (1988).

18. See *Transpac Drilling Venture v. United States*, 26 Cl. Ct. 1245, 1249 (1992) (rejecting plaintiff's request for court appointment of TMP), *aff'd*, 16 F.3d 383 (Fed. Cir. 1994).

19. *Id.*

20. 16 F.3d 383 (Fed. Cir.), *cert. denied*, 115 S. Ct. 79 (1994).

21. *Transpac Drilling Venture v. United States*, 16 F.3d 383, 390 (Fed. Cir.), *cert. denied*, 115 S. Ct. 79 (1994).

which require TMPs be general partners.<sup>22</sup> None of TDVs' filing partners were general partners because none of them assumed unlimited partnership liability.<sup>23</sup> The court held that the limited partners could not be general partners solely to serve as TMP, without assuming all the rights and liabilities of general partners.<sup>24</sup> Accordingly, at the time of filing, or at any time within the ninety-day period reserved for the TMP to file a readjustment petition, no qualified TMP had filed a petition in this case.<sup>25</sup>

Taxpayers argued that the court had the authority and therefore should *sua sponte* appoint the filing partner as the TMP,<sup>26</sup> citing the IRS's authority to appoint a limited partner as TMP in certain circumstances.<sup>27</sup> Taxpayers also argued that § 6231(a)(7) should control only the administrative, not the judicial, stage of the proceeding.<sup>28</sup> Once litigation has begun, taxpayers argued, partnerships should be able to choose any TMP to represent them in court proceedings.<sup>29</sup> Finally, the plaintiff taxpayers argued that failure to allow limited partners to serve as TMPs in these cases would impair their due process right to proceed in their forum of choice.<sup>30</sup>

The Federal Circuit, however, was unpersuaded by the taxpayers' argument, and concluded that the Claims Court had properly held jurisdiction that had not been established by either an individual or entity TMP.<sup>31</sup> The court declined the taxpayers' invitation to appoint a limited partner as TMP, stating that while the IRS had the authority to appoint a limited partner as TMP, it had not done so in this case.<sup>32</sup> The court disposed of plaintiffs' due process argument by viewing the case as a simple choice of forum question, and holding that, although taxpayers would prefer to litigate in the Claims Court, their due process rights would not be violated by requiring them to

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22. *Id.* at 388.

23. *See id.* (stating that plaintiffs "agreed to be limited partners for the limited purpose only of serving as the TMP," not to assume unlimited liability).

24. *Id.*

25. *Id.*

26. *Id.* (explaining taxpayer's assertion that filing partners should be appointed TMPs because large percentage of partners agreed to this in vote taken after filing).

27. *See id.*

28. *See id.* (noting plaintiffs' argument that temporary regulations do not control once FPAA has been issued to partnership).

29. *See id.* (explaining plaintiffs' argument that all partnerships are required to have TMPs for judicial proceedings).

30. *See id.* at 390 (dismissing plaintiffs' argument that IRS should not be allowed to designate its opponents' representative or to leave opponent without one).

31. *Id.*

32. *See id.* at 388 (explaining that IRS was unaware of Adams' resignation until after subject petitions were filed and had, therefore, not designated new TMP).

proceed in the Tax Court.<sup>33</sup> The decision of the Federal Circuit did not conclude the litigation in this case, but merely shifted the forum to the Tax Court.

In *Mulholland v. United States*,<sup>34</sup> the taxpayers were limited partners of a partnership, Quincy Associates, Ltd.<sup>35</sup> In 1980 Quincy purchased a shopping center in Quincy, Florida with a \$192,000 cash deposit. The company financed the balance of the purchase price with a \$7.3 million twenty-three year nonrecourse note (\$2.3 million in principal and \$5 million in interest).<sup>36</sup> The note stated no interest rate. The interest could, however, be prepaid, and if the taxpayers elected to do so, interest to date could be computed using the Rule of 78's accounting method.<sup>37</sup> On its 1981 and 1982 partnership tax returns, Quincy reported and deducted accrued interest under the Rule of 78's, and the Mulhollands claimed their pass through share on their individual tax returns for those years.<sup>38</sup>

The Rule of 78's is an accounting method whereby the total interest to be paid under an installment contract is determined under the sum-of-the-years-digits formula.<sup>39</sup> The Rule of 78's method allows a significant acceleration of interest deductions to the early years of the loan.<sup>40</sup> The IRS in Revenue Ruling 83-84<sup>41</sup> disallowed use of the Rule of 78's method, which had been used principally by tax shelter partnerships, and in Revenue Procedure 84-28<sup>42</sup> created procedures to change from the Rule of 78's to a proper accounting method.<sup>43</sup>

After auditing the partnership return in this case, the IRS concluded that the partnership's use of the Rule of 78's did not "clearly

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33. *Id.* at 390.

34. 22 F.3d 1105 (Fed. Cir. 1994), *aff'g* 28 Fed. Cl. 320 (1993).

35. *Mulholland v. United States*, 28 Fed. Cl. 320, 322 (1993).

36. *See id.* at 325 (detailing financial aspects of transaction).

37. *Id.*

38. *See id.* (noting Quincy's allocation of interest expenses pursuant to Rule of 78's method of accounting, although no prepayments were made during 1981 or 1982).

39. *See* *Mulholland v. United States*, 25 Cl. Ct. 748, 750 n.4 (1992) (explaining Rule of 78's allocation method, which multiplies total amount of loan's interest by number of remaining months to maturity divided by sum of months in original term).

40. *See* Walter C. Cliff & Philip J. Levine, *Interest Accrual and the Time Value of Money*, 35 AM. U. L. REV. 107, 110 (1985) (explaining that, in early years, Rule of 78's deductions exceed those resulting from straight-line or constant interest accounting method).

41. 1983-1 C.B. 97 (1983).

42. 1984-1 C.B. 475 (1984).

43. *See id.* (outlining procedure to apply to lenders and borrowers in violation of Rev. Rul. 83-84, which disallowed Rule of 78's accounting). *See generally* George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 687-88 (1985) (describing effects of Deficit Reduction Act of 1984 on curbing deductions accelerated by prepayments); Cliff & Levine, *supra* note 40, at 110 (explaining generally use of Rule of 78's as accrual method to achieve favorable tax treatment).

reflect income" under § 446(b),<sup>44</sup> and required the partnership to use the economic accrual method in reporting its interest expense.<sup>45</sup> Although the years in issue preceded the issuance of Revenue Ruling 83-84, the IRS disallowed the portion of the interest expense claimed that exceeded the amount allowable under the economic accrual method of accounting.<sup>46</sup>

The Claims Court upheld the Government's position,<sup>47</sup> and the Federal Circuit affirmed.<sup>48</sup> Both courts held that the Government did not abuse its discretion in requiring Quincy to change its accounting method for interest deductions beginning with the tax year 1981 because of the distortive effect caused by the Rule of 78's.<sup>49</sup> Under that method, the court stated, the partnership was paying an effective interest rate of 18.8% at the beginning of the loan and 0.5% at the end.<sup>50</sup> The court concluded that market forces or general business conditions are not relevant to reporting interest accruals in this manner.<sup>51</sup> The partnership was not obligated to make interest payments consistent with the Rule of 78's except in the event of a prepayment, and no prepayment occurred here.<sup>52</sup>

The court further held that the taxpayers were not entitled to use the change in accounting procedures described in Revenue Procedure 84-28, which would have given them relief by allocating the adjustment amount over a multi-year period, because they had failed to file Form 3115, as required by that Revenue Procedure.<sup>53</sup>

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44. *Mulholland v. United States*, No. 93-5158, 1994 U.S. App. LEXIS 5109, at \*1 (Fed. Cir. Mar. 18, 1994); cf. 35 U.S.C. § 446(b) (1988) (stating that taxpayers' accounting methods must clearly reflect income).

45. See *Mulholland*, 1994 U.S. App. LEXIS 5109, at \*2 (affirming trial court's holding that IRS did not abuse discretion in ordering Quincy to change its method of calculating interest).

46. See *id.* (affirming trial court's determination that Quincy was not entitled to benefits of Revenue Procedure 84-28, which outlined procedures for changing from Rule of 78's to proper accounting method).

47. *Mulholland v. United States*, 28 Fed. Cl. 320, 340 (1993) (sustaining IRS conclusion that Quincy should switch from Rule of 78's to economic accrual method of accounting).

48. See *Mulholland*, 1994 U.S. App. LEXIS 5109, at \*2 (disallowing plaintiffs' use of Revenue Procedure 84-28 to unilaterally change its accounting methods).

49. *Id.* at \*8 (concluding that Quincy's use of Rule of 78's on long-term note resulted in improper bunching of disproportionate amount of interest to early years with negligible amounts in later years).

50. *Id.*

51. See *id.* at \*9 (stating that determining amount of interest pursuant to Rule of 78's does not take into consideration market interest rate, transaction risks or inflation).

52. *Id.* at \*7.

53. See *id.* at \*12 (requiring filing of Form 3115 for changing accrual method without IRS Commissioner's permission).

The Federal Circuit's decision in *Mulholland* is consistent with a factually similar case decided by the Tax Court and affirmed by the Third Circuit.<sup>54</sup>

## II. JURISDICTIONAL QUESTIONS

In addition to *Transpac Drilling Venture v. United States*, discussed above,<sup>55</sup> the Federal Circuit considered three other cases involving jurisdictional issues.

In *Chicago Milwaukee Corp. v. United States*,<sup>56</sup> the court considered what an employer must do to establish jurisdiction in the Claims Court in order to claim a refund of taxes paid under the employee portion of the Railroad Retirement Tax Act (RRTA).<sup>57</sup> The RRTA<sup>58</sup> tax is similar to the Federal Insurance Contribution Act tax (FICA),<sup>59</sup> in that it is shared between employer and employee.<sup>60</sup> The employer withholds the employee portion from wages and remits both the employee and employer portion to the Government.<sup>61</sup>

The taxpayer in this case, Chicago Milwaukee Corporation (CMC), was the successor in interest to a bankrupt railroad corporation.<sup>62</sup> Following a sale of the railroad corporation's assets, CMC concluded that it was no longer an employer for RRTA purposes and sought a refund of RRTA taxes paid.<sup>63</sup>

Section 7422(a) of the tax code requires taxpayers wishing to bring refund claims before the Claims Court and federal district courts, to file a refund claim with the IRS prior to bringing the action.<sup>64</sup> The refund claim must comply with all IRS regulations and must apprise

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54. See *Prabel v. Commissioner*, 91 T.C. 1101 (1988), *aff'd*, 882 F.2d 820, 826-27 (3d Cir. 1989) (disallowing plaintiff's use of Rule of 78's to calculate interest deductions because it did not result in clear reflection of income).

55. See *supra* notes 8-33 and accompanying text.

56. 40 F.3d 373 (Fed. Cir. 1994).

57. *Chicago Milwaukee Corp. v. United States*, 40 F.3d 373, 374 (Fed. Cir. 1994) (discussing court's lack of jurisdiction over Chicago Milwaukee Corporation's refund request based on fact that corporation did not certify, as required by IRS, that it had repaid its employees or obtained their consent to seek refund).

58. I.R.C. §§ 3201-3233 (1988).

59. 35 U.S.C. §§ 3101-3128 (1988).

60. Compare 35 U.S.C. § 3101 (1988) (creating federal income tax) and 35 U.S.C. § 3111 (1988) (creating federal employer excise tax) with 35 U.S.C. § 3201 (1988) (creating federal tax on employee incomes) and 35 U.S.C. § 3221 (1988) (creating federal excise tax).

61. See 35 U.S.C. § 3202 (1988) (stating that employers shall collect federal income tax created by § 3201, by deducting appropriate amounts from employee paychecks).

62. *Chicago Milwaukee Corp. v. United States*, 40 F.3d 373, 374 (Fed. Cir. 1994).

63. See *id.* (discussing CMC's conclusion that RRTA did not apply to distributions made).

64. See 35 U.S.C. § 7422(a) (1988) (stating that taxpayers cannot file suit for tax refunds prior to filing refund claim with IRS).

the IRS of the factual and legal basis for the claim.<sup>65</sup> Without this administrative filing, the refund court has no jurisdiction over a subsequent claim.<sup>66</sup>

Under RRTA regulations,<sup>67</sup> employers who seek a refund of the employee portion of RRTA taxes must certify that they have repaid the tax to their employees or obtained their consent to bring the refund action.<sup>68</sup> The question presented in this case concerned the timing requirement of certification.<sup>69</sup>

The Federal Circuit held that despite CMC's failure to certify and obtain its employees' consent to the refund action in this case, the Claims Court had jurisdiction to hear the case.<sup>70</sup> The Federal Circuit reasoned that, although certification is required, there is no requirement that a claim for refund must include certification when filed.<sup>71</sup> The Federal Circuit construed § 7422(a) as a notice provision that informs the IRS Commissioner of the asserted grounds of a refund claim before an action is filed.<sup>72</sup> The certification requirement, on the other hand, prevents an employer from reaping a windfall at the expense of its employees.<sup>73</sup> Accordingly, certification can occur at any time before the refund is made.<sup>74</sup> In *Chicago Milwaukee Corp.*, the court held that requiring CMC to compensate 8000 former employees or obtain their consent before filing an action would constitute an unreasonable burden.<sup>75</sup>

In *Estate of Akin v. United States*,<sup>76</sup> the Federal Circuit held that the Court of Federal Claims had properly applied the full payment rule of *Flora v. United States*,<sup>77</sup> which requires that all outstanding tax deficiencies be paid in full prior to bringing refund actions in the Claims Court.<sup>78</sup> Because deficiencies were unpaid at the time the

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65. See Treas. Reg. § 301.6402-2(b)(1) (as amended in 1977) (disallowing refunds unless claim sets forth detailed grounds for refund).

66. See *Chicago Milwaukee Corp.*, 40 F.3d at 374 (stating that filing refund requirement with IRS is jurisdictional prerequisite to refund suit) (citations omitted).

67. Treas. Reg. § 31.6402(a)(2) (1994).

68. See *id.* (explaining requirements).

69. See *Chicago Milwaukee Corp.*, 40 F.3d at 375 (stating that Treasury regulations do not impose certification deadlines).

70. See *id.* at 374 (reversing and remanding Claims Court dismissal for lack of jurisdiction).

71. See *id.* at 375 (noting that Treasury regulations neither require nor prohibit inclusion of certification at time of filing).

72. *Id.* at 374.

73. *Id.* at 374-75.

74. *Id.* at 375.

75. See *id.* at 376 (describing dismissal of CMC's claim as harsh and "without good reason").

76. 43 F.3d 1487 (Fed. Cir. 1994).

77. 357 U.S. 63 (1958), *aff'd on reh'g*, 362 U.S. 145, 177 (1960).

78. See *Flora v. United States*, 357 U.S. 63, 74-75 (1958) (explaining legislative history of "pay first and litigate later" principle); *Estate of Akin v. United States*, 31 Fed. Cl. 89, 93 (1994) (upholding jurisdictional grant to Claims Court in tax refund cases only when taxpayer, prior



Claims Court petition was filed, the court lacked jurisdiction to hear the claim.<sup>79</sup>

Additionally, in *Sceili v. United States*<sup>80</sup> the Federal Circuit stated that the Claims Court had properly determined that it lacked jurisdiction to hear a complaint seeking a refund of interest on a tax deficiency.<sup>81</sup> Although § 6404(e) gives the Commissioner authority to abate interest in certain circumstances,<sup>82</sup> the Commissioner's failure to exercise that authority in this instance was discretionary and not subject to judicial review.<sup>83</sup>

### III. PERSONAL INJURY AWARDS

In *Reese v. United States*,<sup>84</sup> the Federal Circuit considered the case of Elizabeth Reese, who won a jury award of \$140,000 in compensatory damages and \$100,000 in punitive damages in connection with a lawsuit brought against her former employer for sex discrimination, sexual harassment, and intentional infliction of emotional distress.<sup>85</sup> She won an additional \$10,000 for breach of contract and \$239,437.01 in attorney's fees.<sup>86</sup> Reese initially reported the punitive damages portion of the award as taxable income, but later filed an amended return treating the punitive damages as excludable from income under § 104(a)(2).<sup>87</sup> When her claim for refund was denied by the IRS, Reese filed a refund suit in the Claims Court.<sup>88</sup>

On cross motions for summary judgment, the Claims Court concluded that punitive damages are taxable and granted the

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to commencement of refund suit, has fully paid all outstanding tax deficiencies for taxable year at issue).

79. See *Estate of Akin v. United States*, No. 94-5117, 1994 U.S. App. LEXIS 35547, at \*2 (Fed. Cir. Dec. 19, 1994) (finding no error in dismissal for lack of jurisdiction). For a recent exposition on the "full payment rule" by the Federal Circuit, see *Rocovich v. United States*, 933 F.2d 991, 993 (Fed. Cir. 1991) (upholding determination that *Flora* requires full payment of estate tax before commencing refund suit).

80. 39 F.3d 1197 (Fed. Cir. 1994).

81. *Sceili v. United States*, No. 94-5101, 1994 U.S. App. LEXIS 29310, at \*1 (Fed. Cir. Oct. 14, 1994).

82. See I.R.C. § 6404(e) (1988) (giving IRS power to abate assessment of interest attributable to IRS errors and delays).

83. See *Sceili*, 1994 U.S. App. LEXIS 29310, at \*5 (using statutory language to reach conclusion that authority of IRS to abate interest is discretionary).

84. 20 Fed. Cl. 702 (1993), *aff'd*, 24 F.3d 228 (Fed. Cir. 1994).

85. *Reese v. United States*, 20 Fed. Cl. 702, 703 (1993), *aff'd*, 24 F.3d 228 (Fed. Cir. 1994).

86. *Id.*

87. I.R.C. § 104(a)(2) (1988) (providing that damages received on account of personal injuries are not included in gross income).

88. *Id.*

Government's motion.<sup>89</sup> The Federal Circuit affirmed the Claims Court's holding.<sup>90</sup>

Section 104(a)(2) provides that gross income does not include "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness."<sup>91</sup> The issue of whether punitive damages received in a personal injury suit are excludable from income under § 104(a)(2)—or whether that section is limited to compensatory damages—has been litigated extensively. To date, the Tax Court<sup>92</sup> and the Sixth Circuit<sup>93</sup> have lined up on the taxpayer's side, holding that § 104(a)(2) excludes *all* damages received in connection with a personal injury suit, including punitive damages.<sup>94</sup> These courts interpreted the language of the statute, which excludes from income "*any* damages received . . . on account of personal injuries," to require only an evaluation of the nature of the underlying injury.<sup>95</sup> If the claim involves a tort-like personal injury,<sup>96</sup> all damages received in connection with it are excludable.<sup>97</sup>

The Fourth,<sup>98</sup> Ninth,<sup>99</sup> and now the Federal Circuit,<sup>100</sup> as well

89. See *id.* at 711 (holding that punitive damages fall outside exclusion from taxable gross income set forth in I.R.C. § 104(a)(2)).

90. *Reese v. United States*, 24 F.3d 228, 235 (Fed. Cir. 1994).

91. I.R.C. § 104(a)(2) (1988).

92. See *Miller v. Commissioner*, 93 T.C. 330, 335 (1989), *rev'd*, 914 F.2d 586 (4th Cir. 1990) (holding that settlement proceeds of Maryland lawsuits for defamation and intentional infliction of emotional distress are not subject to federal income tax).

93. See *Horton v. Commissioner*, 33 F.3d 625, 625-26 (6th Cir. 1994), *aff'g* 100 T.C. 93 (1993) (excluding taxpayer's punitive damages under § 104(a)(2)).

94. *Horton*, 33 F.3d at 629-31 (explaining that damages described in compensatory terms that are not excludable from income under I.R.C. § 104(a)(2) (1988) are often larger than amount necessary to reimburse actual monetary loss sustained, and should instead be categorized as excludable damages received on account of personal injuries).

95. *Miller*, 93 T.C. at 335-38 (emphasis added).

96. Treas. Reg. § 1.104-1(c) (as amended in 1970) provides:

Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

*Id.*

97. See *Horton*, 33 F.3d at 629 (explaining plaintiff's burden of proof to show that recovery redresses tort-like personal injury and arguing therefore that such recovery should be excluded from income).

98. See *Commissioner v. Miller*, 914 F.2d 586, 589 (4th Cir. 1990) (rejecting conclusion that plain meaning of § 104(a)(2) compels exclusion of punitive damages from gross income).

99. See *Hawkins v. United States*, 30 F.3d 1077, 1084 (9th Cir. 1994) (stating that no valid reason existed to exempt punitive award from taxation).

100. See *Reese v. United States*, 24 F.3d 228, 235 (Fed. Cir. 1994) (concluding that because punitive damages are not received on account of personal injury as defined by Tax Code, they are not excludable from income under § 104(a)(2)).

as several lower courts,<sup>101</sup> have interpreted § 104(a)(2) in favor of the Government. These courts have held that punitive damages are not within the exclusion of § 104(a)(2) because they are not awarded "on account of" personal injuries of the plaintiff.<sup>102</sup> Rather, punitive damages are imposed to punish tortfeasors' grossly negligent behavior and to deter such conduct in others.<sup>103</sup>

The Federal Circuit in *Reese* looked to the legislative history of § 104(a)(2) to conclude that the taxpayer's punitive damages were not paid on account of her personal injury. The legislative history indicates that Congress did not intend to exclude punitive damages from gross income.<sup>104</sup> The court concluded that Congress enacted § 104(a)(2) to ensure that payments representing only recovery of a loss, or return of personal capital, would not be taxed.<sup>105</sup> Because punitive damages are not a return of capital but windfalls to the taxpayer and clear economic accessions to wealth, the court reasoned that it would be inconsistent with the legislative purpose to exclude them.<sup>106</sup>

It is noteworthy that Congress amended § 104(a)(2) in 1989, specifically to exclude punitive damage awards received "in connection with a case not involving physical injury or physical sickness"<sup>107</sup> from the section's scope. The amendment applies, for example, to damages in employment discrimination, defamation, or harassment suits, much like *Reese*. Accordingly, the Federal Circuit's opinion in *Reese* is consistent with the statutory rule now in place for cases involving nonphysical injuries.<sup>108</sup> It is unclear whether the 1989 legislative amendment creates a negative inference and would therefore exclude punitive damages from income in cases involving

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101. See, e.g., *Estate of Wesson v. United States*, 843 F. Supp. 1119, 1123 (S.D. Miss. 1994) (finding that net punitive damages are taxable accession of wealth to plaintiff); *Rice v. United States*, 834 F. Supp. 1241, 1246 (E.D. Cal. 1993) (holding that punitive damages awarded under Age Discrimination in Employment Act (ADEA) are taxable income); *Kemp v. Commissioner*, 771 F. Supp. 357, 359 (N.D. Ga. 1991) (concluding that punitive damages awarded in civil rights action constitute gross income).

102. See *Reese*, 24 F.3d at 230-31 (discussing decisions finding punitive damages taxable).

103. See *id.* (explaining Government position that punitive damages are awarded not because of personal injury but because of defendants' "egregious conduct").

104. *Id.*

105. See *id.* (stating that damages excludable under § 104(a)(2) encompass only damages resulting from injury or sickness).

106. *Id.* at 231-32.

107. I.R.C. § 104(a) (1988 & Supp. V 1993).

108. See *Reese*, 24 F.3d at 235 (upholding inclusion in gross income of punitive damages not received on account of personal injury within the meaning of I.R.C. § 104(a)(2)). The court in *Reese* also noted that cases excluding punitive damages from gross income are based on an IRS revenue ruling that has since been revoked. *Id.*

physical injuries. One author has argued in the negative,<sup>109</sup> but no court has ruled on the issue to date.

In *Reese*, the Federal Circuit also noted that when a statute allowing an exemption from income is ambiguous and susceptible to two interpretations, it should be narrowly construed in light of the overall purpose of the income tax laws, which is to raise revenue.<sup>110</sup>

The punitive damages issue involved in *Reese* is only one of several interpretative issues that have arisen under § 104(a)(2) in the last several years. In 1992, the Supreme Court considered this statute in *Burke v. United States*,<sup>111</sup> which discussed the excludability of a back pay award in a sex discrimination suit under the pre-1991 version of Title VII of the Civil Rights Act of 1964.<sup>112</sup> The Court held that for § 104(a)(2) to apply, the underlying claim must involve a tort-like injury, a hallmark of which is the availability of a broad range of damages, including punitive or exemplary damages in those instances where the defendant's misconduct is intentional or reckless.<sup>113</sup> In *Burke*, the Court determined that the pre-1991 Title VII<sup>114</sup> did not provide such a broad range of damages, but, to the contrary, limited the plaintiff's recovery to back pay and injunctive relief.<sup>115</sup> The Court concluded that Title VII recovery in this case was not "on account of personal injury" within the meaning of § 104(a)(2) and was therefore taxable.<sup>116</sup>

In addition to *Burke*, a number of recent cases<sup>117</sup> have addressed the excludability of damages (including liquidated damages) received by plaintiffs in connection with age discrimination actions under the Age Discrimination in Employment Act (ADEA).<sup>118</sup> In February

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109. See Douglas A. Kahn, *Taxation of Punitive Damages Obtained in a Personal Injury Claim*, 65 TAX NOTES 487, 490 (1994) (stating that 1989 amendment has no bearing on excludability of punitive damages connected with physical injury).

110. See *id.* (noting that long-standing precedent favors inclusion of all accessions to wealth in gross income).

111. 504 U.S. 229 (1992).

112. Pub. L. No. 88-352, 78 Stat. 253 (codified as amended at 42 U.S.C. § 2000e (1988)).

113. See *Burke v. United States*, 504 U.S. 229, 234-37 (1992) (explaining personal injury victim's range of recoverable damages under state law).

114. Congress has since amended Title VII to permit jury trials, as well as compensatory and punitive damage awards for Title VII actions. Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071 (codified at 42 U.S.C. § 1981 (1988)).

115. *Burke*, 504 U.S. at 239-40.

116. *Id.* at 241-42.

117. See, e.g., *Schmitz v. Commissioner*, 34 F.3d 790, 796 (9th Cir. 1994) (excluding from gross income liquidated damages collected on account of personal injury); *Downey v. Commissioner*, 33 F.3d 836, 840 (7th Cir. 1994) (including in gross income liquidated damages collected under ADEA); *Schleier v. Commissioner*, 26 F.3d 1119, 1119 (5th Cir. 1994) (holding that damages are excludable from gross income), *rev'd*, 115 S. Ct. 2159 (1995).

118. 29 U.S.C. §§ 621-634 (1988).

1994, the Claims Court decided *Bennett v. United States*.<sup>119</sup> The court found the ADEA award nontaxable under § 104(a)(2).<sup>120</sup> Due to a conflict among the circuits,<sup>121</sup> the Supreme Court granted certiorari in *Schleier v. Commissioner*<sup>122</sup> to resolve the issue. In June 1995, the Supreme Court held that the ADEA recovery (both back pay and liquidated damages portions) were not excludable from gross income.<sup>123</sup> The Federal Circuit thereafter reversed the Claims Court's decision in *Bennett*, based on *Schleier*.<sup>124</sup>

In *Schleier*, the Supreme Court described the ADEA liquidated damages as "punitive in nature."<sup>125</sup> Based on this description of liquidated damages and its holding that the liquidated damages were not excludable under § 104(a)(2),<sup>126</sup> the Court's opinion strongly suggests that punitive damages can never be excluded under § 104(a)(2) and that *Reese* was correctly decided.

#### IV. DISABILITY RETIREMENT PAYMENTS

The Federal Circuit made another foray into § 104 in 1994. In *Kane v. United States*,<sup>127</sup> the taxpayer was a federal judge who retired from the bench in 1988 after being diagnosed with stress-related sleep apnea.<sup>128</sup> The taxpayer sought to exclude the disability payments he received in connection with this condition from his taxable income under § 104(a)(1),<sup>129</sup> which excludes from income "amounts received under workmen's compensation acts as compensation for personal injuries or sickness."<sup>130</sup> The taxpayer's position was that the statute under which he received his disability payments was "in the nature of a workman's compensation act" because payments were provided for a work-related injury.<sup>131</sup>

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119. 30 Fed. Cl. 396 (1994).

120. See *Bennett v. United States*, 30 Fed. Cl. 396, 399-401 (1994) (finding damages awarded under ADEA excludable because ADEA redresses tort-like personal injuries).

121. See *supra* note 117 (citing cases that indicate differences among circuits in their treatment of ADEA damage awards).

122. 115 S. Ct. 507 (1994).

123. *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995).

124. *Bennett v. United States*, No. 94-5117, 1995 U.S. App. LEXIS 16849 (Fed. Cir. July 10, 1995).

125. *Schleier*, 115 S. Ct. at 2165.

126. *Id.* at 2167.

127. 43 F.3d 1446 (Fed. Cir. 1994).

128. *Kane v. United States*, 43 F.3d 1446, 1447 (Fed. Cir. 1994).

129. See *id.* at 1448 (detailing arguments that taxpayer set forth in amended tax returns).

130. I.R.C. § 104(a)(1) (1988).

131. *Kane*, 43 F.3d at 1449.

Both the Claims Court<sup>132</sup> and the Federal Circuit disagreed with the taxpayer's position. In a decision the Federal Circuit described as one of first impression,<sup>133</sup> the court reasoned that workmen's compensation statutes provide payments to employees in cases involving employment-related accidents and diseases, regardless of employer fault.<sup>134</sup> Accordingly, they could be considered no-fault substitutes for compensation that the employee might have received based on a theory of employer liability.<sup>135</sup> This case, however, involved the taxpayer's retirement plan, which was not concerned with employer liability.<sup>136</sup> The retirement plan provided for a continuation of salary and benefits in an amount tied to the taxpayer's length of service as a judge.<sup>137</sup> As such, the plan did not relieve the Government of any liability it might otherwise be exposed to as a result of the taxpayer's disability.<sup>138</sup> For this reason, the court found the compensation plan very different from a workman's compensation statute, and the taxpayer's disability payments were, accordingly, not excludable under § 104(a)(1).<sup>139</sup>

In holding against the taxpayer, the court also referred to a Treasury Regulation, section 1.104-1(b), which states that "§ 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service . . . even though the employee's retirement is occasioned by an occupation injury or sickness."<sup>140</sup>

## V. FICA WITHHOLDING REQUIRED

In *Euken v. Department of Health and Human Services*,<sup>141</sup> Corey Euken suffered a residual seizure disorder, developmental delays, and mental disabilities in reaction to DPT shots for diphtheria, pertussis, and tetanus.<sup>142</sup> Under the National Childhood Vaccine Injury Act of 1986,<sup>143</sup> Corey petitioned for and received a compensation award

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132. See *Kane v. United States*, 28 Fed. Cl. 10, 14 (1993) (holding that disability retirement payments were not in nature of workmen's compensation act).

133. *Kane*, 43 F.3d at 1448.

134. *Id.* at 1449.

135. *Id.*

136. *Id.*

137. See *id.* (explaining that disability retirement provision supported continuation of either full or half salary, depending on tenure).

138. *Id.*

139. See *id.*

140. Treas. Reg. § 1.104-1(b) (as amended in 1970).

141. 34 F.3d 1045 (Fed. Cir. 1994).

142. *Euken v. Department of Health & Human Servs.*, 34 F.3d 1045, 1046 (Fed. Cir. 1994).

143. 42 U.S.C. §§ 300aa-10 to -34 (1988).

for his injuries, as determined by a Special Master.<sup>144</sup> As part of the award, he received compensation for loss of earning capacity pursuant to 42 U.S.C. § 300aa-15(a)(3)(B).<sup>145</sup> This statute allows a lost earnings award calculated on the basis of average gross weekly earnings of workers in the private, non-farm sector, less appropriate taxes.<sup>146</sup> The Special Master determined the award amount after deducting an amount equal to income taxes payable on the earnings, but did not deduct FICA tax in the computation.<sup>147</sup> The Special Master reasoned that FICA was not an appropriate tax because the taxpayer would not, as a normally employed person would, receive the FICA tax once he attained the age of sixty-five.<sup>148</sup>

The Federal Circuit disagreed with the Special Master's analysis. The court stated that under the statutory scheme, FICA is an appropriate tax if a private sector worker would normally deduct FICA from their average gross weekly earnings.<sup>149</sup> The court concluded that, while narrow exceptions do exist, in most cases, private sector workers pay FICA taxes on their wages.<sup>150</sup> The court determined that the particular work status of the beneficiary in this instance was irrelevant, because the rule to deduct the FICA tax is an objective and not a subjective one.<sup>151</sup>

Although the scope and breadth of the FICA tax base continues to be an important question, for example, in the employee-independent contractor context,<sup>152</sup> the facts of *Euken* are so unusual that the court's decision in that case is likely to have little precedential impact.

## VI. RESPONSIBLE PERSON PENALTY UPHOLD

An employer is required to withhold federal income and FICA taxes from employees, hold them in trust, and pay them to the IRS.<sup>153</sup>

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144. See *Euken*, 34 F.3d at 1046 (stating that, after filing petition for compensation under Vaccine Act, Special Master determines entitlement and amount of award).

145. *Id.* at 1046-47.

146. 42 U.S.C. § 300aa-15(a)(3)(B) (1988).

147. See *Euken*, 34 F.3d at 1047 (noting Special Master's determination that beginning in year 2007, average annual earnings for 40-hour work week would total \$28,715.58).

148. *Id.*

149. *Id.* at 1048.

150. *Id.*

151. *Id.*

152. See, e.g., Louis Lyons, *Congressional Campaign Workers: Independent Contractors or Employees? Politics, Taxes, and the Limits of the Internal Revenue Service's Authority Over Employment Classification*, 8 ADMIN. L.J. AM. U. 371, 391-401 (1994) (discussing range of tax issues raised by classifying campaign workers as independent contractors versus employees); Matthew J. Rita, *Fishing for Dollars: The IRS Changes Course in Classifying Fishermen for Employment Tax Purposes*, 77 CORNELL L. REV. 393, 415-38 (1992) (examining recent debate regarding how captains and crew members of fishing boats should be classified).

153. I.R.C. § 7501 (1988).

The amounts are generally referred to as trust fund taxes.<sup>154</sup> When businesses have delinquent bills from creditors and are facing a cash crunch, the owners often use trust fund taxes to pay the current business creditors instead of forwarding them to the U.S. Treasury.<sup>155</sup> Not uncommonly, the owners convince themselves that their economic problems are temporary, and by the time they hear from the IRS, they will have had time to improve their cash flow and pay their tax debt.<sup>156</sup> This "unauthorized borrowing" poses a serious, though not unfamiliar, threat to the collection of social security taxes.<sup>157</sup>

Under § 6672(a), any person responsible for collection and payment of trust fund taxes who willfully fails to pay them is subject to a penalty equal to 100% of the trust fund taxes.<sup>158</sup> The purpose of this penalty (sometimes referred to as "the 100% penalty" or the "responsible person" penalty) is to encourage payment of the trust fund taxes when due, and to discourage the use of trust fund taxes for other business needs.<sup>159</sup> When these taxes are not paid, § 6672 provides the Government with a secondarily liable target.<sup>160</sup> The responsible person penalty is not dischargeable in bankruptcy.<sup>161</sup>

In *Jones v. United States*,<sup>162</sup> the Federal Circuit held that a taxpayer, who was one of three partners in a construction partnership, was a responsible person within the meaning of § 6672 and, thus, liable for the 100% penalty on unpaid trust fund taxes.<sup>163</sup> Although another partner had primarily handled the financial aspects of the operation, the court held that Jones could also be held liable for the penalty because he was an active participant in the business and, among other things, had authority to write checks to pay partnership debts.<sup>164</sup>

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154. See *Kinnie v. United States*, 994 F.2d 279, 283 (6th Cir. 1993) (attributing "trust fund tax" nomenclature to employer's obligation to withhold income tax).

155. *Id.*

156. *Id.*

157. See James C. Seiffert, *IRS's New Approach to Determining "Responsible" Persons for the 100% Penalty*, 79 J. TAX'N 144, 145 (1993) (discussing problems of trust fund misappropriations).

158. I.R.C. § 6672(a) (1988).

159. See *Gephart v. United States*, 818 F.2d 469, 473 (6th Cir. 1987) (per curiam) (interpreting I.R.C. § 6672 as requiring "full amount" penalty for person failing to withhold employees' withholding taxes).

160. I.R.C. § 6672 (1988). Specifically, the statute provides that the "responsible person" shall "be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over." *Id.* § 6672(a).

161. 11 U.S.C. §§ 523(a)(1), 523(a)(7) (1988).

162. No. 94-5041, 1994 U.S. App. LEXIS 10400 (Fed. Cir. May 9, 1994).

163. *Jones v. United States*, No. 94-5041, 1994 U.S. App. LEXIS 10400, at \*2 (Fed. Cir. May 9, 1994).

164. *Id.* Jones argued that only the partner who controlled the financial aspects of the business should be liable for nonpayment of taxes. *Id.* The court, however, emphasized that more than one person can be held liable under § 6672. *Id.*



The court noted that Jones had attended meetings where nonpayment of trust fund taxes was discussed and participated in the decision to use the trust fund taxes for other partnership purposes.<sup>165</sup> The court stated that more than one person could be held liable under § 6672 for nonpayment of trust fund taxes.<sup>166</sup> The standard set forth by the court was whether a person "had the power to control the decision-making process by which the partnership decided to meet its debts to other creditors at the Government's expense."<sup>167</sup>

The Federal Circuit's decision in *Jones* is consistent with the broad approach courts have taken toward liability for the 100% penalty. Courts have found anyone who had control over business finances to be liable, including anyone with decisional authority over which bills should be paid.<sup>168</sup> This case demonstrated that, although others may be more culpable, a relatively innocent person can nonetheless be held a responsible person subject to the same exposure and liability as the more responsible actor.

## VII. STOCK REPURCHASE PREMIUMS NONDEDUCTIBLE

Lane Bryant, Inc. (Lane), a subsidiary of The Limited, Inc., was the subject of a potential hostile takeover by two shareholders.<sup>169</sup> Over a fifteen-month period, the two shareholders acquired approximately twenty percent of Lane's stock.<sup>170</sup> In 1981, Lane entered into negotiated repurchase agreements with both shareholders to buy back

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165. *Id.*

166. *Id.*

167. *Id.*

168. See, e.g., *Denbo v. United States*, 988 F.2d 1029, 1033 (10th Cir. 1993) (stating that responsibility for raising capital, check-signing authority, and general financial involvement were sufficient evidence of responsibility for imposition of liability for nonpayment of taxes); *Thomsen v. United States*, 887 F.2d 12, 16-17 (1st Cir. 1989) (finding that defendant, although not stockholder, was responsible person because of his authority to issue checks, access to company books and records, and joint authority to order payment of taxes); *Brown v. United States*, 591 F.2d 1136, 1140 (5th Cir. 1979) (finding both corporate partners liable for nonpayment of taxes because both had check-writing authority); *Datlof v. United States*, 252 F. Supp. 11, 32 (E.D. Pa.) (holding defendant liable as responsible person based on his check-signing ability, role in employee hiring and firing, signature on tax returns, and general control over business affairs), *aff'd*, 370 F.2d 655 (3d Cir. 1966), *cert. denied*, 387 U.S. 906 (1967). Responsible persons have also been held liable for interest on unpaid trust fund taxes. See *Turchon v. United States*, 77 B.R. 398, 401 (Bankr. E.D.N.Y. 1987), *aff'd sub nom. In re Turchon*, 841 F.2d 1116 (2d Cir. 1988) (holding that liability under § 6672, although deemed penalty, is in fact tax that includes interest, making employer liable for interest on unpaid taxes). See generally MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 55.125 to .126 (1989) (discussing trust fund tax liability).

169. *Lane Bryant, Inc. v. United States*, 35 F.3d 1570, 1571 (Fed. Cir. 1994).

170. *Id.* at 1572.

their stock at a premium above the stock's trading value.<sup>171</sup> The amount of the premium in one of the agreements was \$5.00 per share.<sup>172</sup> In the other, it was \$5.50 per share.<sup>173</sup> The repurchase agreements also contained nonstock terms, such as the cessation of present and future litigation, payment of transfer taxes, warranties of authorization and title, and waiver of dividend rights.<sup>174</sup> There was no allocation of the monetary consideration in the agreements between the stock and nonstock items—all references to the monetary consideration were in the clauses involving the stock sale.<sup>175</sup>

The tax significance of these events occurred when Lane reported a \$5.3 million deduction, representing the amount of its repurchase premiums, on its 1981 federal income tax return.<sup>176</sup> Lane claimed that the premium payments represented compensation for nonstock items, rather than stock, and therefore were deductible as "ordinary and necessary business expense[s]" under the Code.<sup>177</sup> The Government's view, on the other hand, was that, for tax purposes, the total consideration paid should be treated as the cost of the repurchased stock,<sup>178</sup> a nondeductible capital expenditure under § 162(k).<sup>179</sup>

The Claims Court found for the Government, concluding that neither repurchase agreement allocated consideration to the nonstock items and that the language of the agreements was controlling.<sup>180</sup> In reaching its conclusion, the court declined to recognize the asserted intent of the parties—that the premium paid for the stock above its market value was in consideration for the nonstock provisions.<sup>181</sup> The court relied on the *Danielson* rule<sup>182</sup> as well as its own precedent in *Stokely-Van Camp Inc. v. United States*,<sup>183</sup> for the proposition that parties to a written and duly executed agreement are

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171. *Id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.* (citing I.R.C. § 162(a) (1988)).

178. *Id.* at 1573.

179. *See* I.R.C. § 162(k) (1988).

180. *Lane Bryant*, 35 F.3d at 1573.

181. *Id.* (noting that Claims Court read agreement as allocating entire purchase price to stock redemption).

182. *See* Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir.) (en banc) (holding that party can challenge tax consequences of agreement only by proof of contract's unenforceability due to mistake, fraud, undue influence, duress, etc.), *cert. denied*, 389 U.S. 858 (1967).

183. 974 F.2d 1319, 1325 (Fed. Cir. 1992) (holding that *Danielson* rule governs stock repurchase agreements containing express allocations of monetary consideration between stock and non-stock items).

bound, for tax purposes, by the characterizations they make of items in the agreement.<sup>184</sup> Because the Lane repurchase agreements did not allocate any monetary consideration to the nonstock provisions, and all references to the financial consideration for the deals were in the clauses regarding the stock sales, the Claims Court made a factual finding that the repurchase agreements contained an express allocation of all of the monetary consideration to the stock items.<sup>185</sup> Applying *Danielson*, the court found that the taxpayers were legally bound by that finding and, thus, liable for tax payments on the entire amount of the repurchase price.<sup>186</sup>

The Federal Circuit affirmed this holding.<sup>187</sup> In response to the taxpayer's argument that interpreting the repurchase agreements as allocating nothing to the nonstock provisions was illogical and flew in the face of economic sense, the court stated that the *Danielson* rule was an appropriate rule of construction with respect to the tax consequences of private agreements. Additionally, the court stated that the *Danielson* rule prevented the "whipsaw of later inconsistent positions" at the expense of the Government when the parties who drafted the agreement later took tax positions contrary to its language.<sup>188</sup>

The Federal Circuit's decision is consistent with a long line of decisions holding that, while the Government is free in any case to challenge the form of a transaction as inconsistent with its true economic substance,<sup>189</sup> the taxpayer is bound by the form chosen in the transaction and may not later disavow that form.<sup>190</sup>

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184. *Lane Bryant*, 35 F.3d at 1574-75.

185. *See id.* at 1575.

186. *Id.* at 1576.

187. *Id.*

188. *Id.*

189. *See, e.g., Spector v. Commissioner*, 641 F.2d 376, 386 (5th Cir.) (stating that IRS will not be bound by secret, unilateral, subjective allocation of purchase price that is not expressed in agreement), *cert. denied*, 454 U.S. 868 (1981); *Sullivan v. United States*, 618 F.2d 1001, 1007 (3d Cir. 1980) (holding taxpayers' liability is determined by transaction's form).

190. *See, e.g., Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974) (observing that while taxpayers are free to organize affairs as they choose, they must accept consequences of that choice); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935) (stating that tax consequences must turn upon economic substance of transaction rather than timing or transaction form); *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185, 1195 (5th Cir. 1970) (stating that form and substance of transaction determine whether recognition of transaction form would undermine relevant tax position), *cert. denied*, 401 U.S. 939 (1971).

## VIII. ATTORNEYS' FEES

In *Sharp v. United States*,<sup>191</sup> the taxpayer sought an award of attorneys' fees after defeating the Government in a case involving the carryover of investment interest<sup>192</sup> under § 163(d) of the Internal Revenue Code.<sup>193</sup> Under § 7430 of the Code<sup>194</sup> a taxpayer may be awarded attorneys' fees if she is a prevailing party and the Government's position in the underlying action is not substantially justified.<sup>195</sup> Section 7430 was enacted as part of the Tax Equity and Financial Responsibility Act of 1982.<sup>196</sup> The Act's purpose was to permit courts to award attorneys' fees to successful tax litigants in cases where the Government has adopted an unreasonable trial position.<sup>197</sup>

In *Sharp*, the taxpayer argued not only that the Government's position was unreasonable, but also that by the time the Government brought the appeal in his case it had previously lost the identical issue in the Fourth Circuit,<sup>198</sup> in a District court case,<sup>199</sup> and in the Court of Federal Claims.<sup>200</sup> Furthermore, after the taxpayer filed his appeal in this case, the Tax Court had reversed itself and decided the issue adversely to the Government.<sup>201</sup>

In a divided decision, the Federal Circuit denied the award.<sup>202</sup> The court stated that while a string of losses can evidence an unreasonable position, the Government's loss of an issue in one circuit does not render its choice to relitigate that issue as one

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191. 20 F.3d 1153 (Fed. Cir. 1994).

192. *Sharp v. United States*, 20 F.2d 1153, 1154 (Fed. Cir. 1994).

193. I.R.C. § 163(d) (1988). Section 163 allows taxpayers to deduct interest paid or accrued in the current tax year and permits taxpayers to carryover unused investment interest deductions. *Id.*

194. I.R.C. § 7430 (1988). Section 7430 permits the prevailing party to recover reasonable litigation costs in court proceedings brought by or against the United States. *Id.*

195. I.R.C. § 7430(c)(9) (1988).

196. Pub. L. No. 97-248, § 292(a), 96 Stat. 324 (1982) (codified at I.R.C. § 7430 (1988)).

197. *See Sharp*, 20 F.3d at 1154.

198. *Id.* at 1155; *see Beyer v. Commissioner*, 916 F.2d 153, 156 (4th Cir. 1990) (holding that tax code's carry-over provision applies regardless of taxpayer's total taxable income for year).

199. *See Flood v. United States*, 845 F. Supp. 1367, 1371 (D. Alaska 1993) (holding that taxpayer may carry forward investment interest in excess of investment income).

200. *See Sharp v. United States*, 27 Fed. Cl. 52, 57 (1992) (stating that clear and undisputed meaning of § 163 allows taxpayers to deduct interest paid or accrued in current tax year without limitation).

201. *See Lenz v. Commissioner*, 101 T.C. 260, 270 (1993) (holding that carryover of investment interest expense under § 163(d) is not limited by taxpayer's taxable income in current year).

202. *Sharp v. United States*, 20 F.3d 1153, 1154 (Fed. Cir. 1994) (refusing to find Government's position substantially unjustified where at least one court had agreed with Government).

without substantial justification.<sup>203</sup> Moreover, the Government had successfully litigated the issue before the Tax Court,<sup>204</sup> even though the Fourth Circuit ultimately overruled that court.<sup>205</sup> As a result, Sharp did not prove that the Government's position was substantially unjustified and no attorneys' fees were awarded.<sup>206</sup>

Judge Newman, in an angry dissent, argued that attorneys' fees should have been allowed.<sup>207</sup> Newman's opinion cited a statement given by Government's counsel at oral argument that the Government would continue to litigate the same issue until it had lost in at least six circuits.<sup>208</sup> The taxpayer, Newman stated, should not have to pay for the Government's search for a receptive forum.<sup>209</sup>

The majority opinion in the *Sharp* case stands in contrast to the Fifth Circuit's decision in *Allbritton v. Commissioner*.<sup>210</sup> After ruling in favor of the taxpayer on the same underlying issue, the court in *Allbritton* rebuked the Government for forum shopping and invited the taxpayer to apply for attorneys' fees under § 7430.<sup>211</sup>

## IX. TORT LIABILITY SETTLEMENT FUNDS

In *Maxus Energy Corporation v. United States*,<sup>212</sup> the taxpayer was the parent corporation in an affiliated group of corporations (Group) that filed its tax returns on a consolidated basis, using the accrual method of accounting.<sup>213</sup> One corporate member of the group, Diamond Shamrock Chemicals Corporation, was a manufacturer of Agent Orange, the chemical defoliant used in the Vietnam War.<sup>214</sup> In 1984, Diamond settled claims brought by a class of Vietnam

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203. *Id.* at 1154.

204. *Beyer v. Commissioner*, 92 T.C. 1304 (1989) (holding that carry-over provision is subject to implicit limitation equal to taxpayer's total taxable income for year), *rev'd*, 916 F.2d 153 (4th Cir. 1990).

205. *Beyer v. Commissioner*, 916 F.2d 153, 156 (4th Cir. 1990) (holding that carry-over provision is not subject to limitation equal to taxpayer's total taxable income for year).

206. *Sharp*, 20 F.3d at 1154.

207. *Id.* at 1155 (Newman, J., dissenting) (stating that whether Government wins or loses, fundamental fairness precludes requiring successive taxpayers to bear litigation costs).

208. *Id.* (Newman, J., dissenting).

209. *Id.* (Newman, J., dissenting).

210. 37 F.3d 183 (5th Cir. 1994).

211. *Allbritton v. Commissioner*, 37 F.3d 183, 185 (5th Cir. 1994). The Fifth Circuit found that the Government's appeal, based on a statutory interpretation previously rejected by the Fourth Circuit, the Federal Circuit and several district courts, constituted forum shopping at the taxpayer's expense and was not substantially justified; and held that the Commissioner should bear all reasonable costs of the taxpayer's litigation. *Id.*

212. 31 F.3d 1135 (Fed. Cir. 1994).

213. *Maxus Energy Corp. v. United States*, 31 F.3d 1135, 1137 (Fed. Cir. 1994).

214. *Id.*

veterans for injuries resulting from the veterans' exposure to Agent Orange.<sup>215</sup>

Pursuant to the settlement agreement, Diamond agreed to pay \$21.7 million plus interest (out of a total \$180 million settlement) to a court-administered fund from which individual plaintiffs would be compensated.<sup>216</sup> The agreement, with which Diamond complied, required Diamond, to transfer a letter of credit, bond or other acceptable security to secure its payment of the settlement amount by July 2, 1984.<sup>217</sup> Although Diamond had an option to withdraw from the settlement until July 19, 1984, it did not do so.<sup>218</sup> On January 14, 1985 Diamond paid \$23,339,417 to the fund.<sup>219</sup>

The Group deducted the bulk of the settlement amount, \$23,254,217, which accrued in 1984; and the residual portion, \$85,200, which accrued in 1985.<sup>220</sup> Portions of the deduction were carried back and applied against the Group's 1972-75 tax years.<sup>221</sup> At issue before the Federal Circuit was the correct year of the deduction of the settlement liability.<sup>222</sup> The Government challenged the taxpayer's right to claim the deduction in either 1984 or 1985.<sup>223</sup>

After holding that it had jurisdiction to entertain the appeal,<sup>224</sup> the Federal Circuit agreed with the Government as to the deductions claimed in 1984, and determined that the Group was not entitled to claim any part of the deduction in that year.<sup>225</sup> Prior to enactment of the Tax Reform Act of 1984, the general rule was that accrual method taxpayers were entitled to claim a deduction, whether or not they had paid the amount, if all events had occurred that fixed the amount and fact of the underlying liability.<sup>226</sup> Where a liability was contingent or contested, the deduction was not available until the liability became fixed and certain unless it had actually been paid.<sup>227</sup>

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215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* Pursuant to the tax code, deductions for settlement proceeds are product liability losses. These losses can be carried back to each of the preceding 10 taxable years. As a result, taxpayers can amend their returns and apply a portion of their settlements as deductions for each of the preceding years. I.R.C. § 172(b)(1)(I) (1988).

222. *Maxus Energy*, 31 F.3d at 1142.

223. *Id.* (arguing that Maxus was not entitled to deduction because all events surrounding settlement had not yet occurred).

224. *Id.* at 1139.

225. *Id.* at 1142.

226. I.R.C. § 461 (1982); Treas. Reg. § 1.461-1(a)(2)(i) (1984).

227. I.R.C. § 461(f) (1982); Treas. Reg. § 1.461-2 (1984).

For the tax year 1984, the court found that the "all events" test was met on July 19, when the Group's option to withdraw from the settlement expired.<sup>228</sup> Under the all events test, the deduction would normally have been allowed at that time.<sup>229</sup> Just a few weeks earlier, however, Congress had enacted the Tax Reform Act of 1984, which contained an amended § 461(h).<sup>230</sup> That section provides that an accrual basis taxpayer cannot deduct an accrued expense, even if the "all events" test has been met, unless economic performance has occurred with respect to the item.<sup>231</sup> Insofar as tort liabilities are concerned, the court held that economic performance occurs when there is an actual payment of the liability.<sup>232</sup> Because Diamond made no actual payment in 1984, no deduction was allowable for that year under the economic performance test.<sup>233</sup>

In 1985, Diamond did make a payment to the fund.<sup>234</sup> With respect to the 1985 tax year, however, the Government challenged the deduction on the ground that the fund was a designated settlement fund within the meaning of § 468B; and that no deductions were permissible until disbursement to the individual claimants had occurred.<sup>235</sup> Under § 468B the economic performance requirement of § 461(h) is met when "qualified payments" are made into a "designated settlement fund (DSF)."<sup>236</sup> A DSF is a fund created pursuant to a court order which completely extinguishes the taxpayers' tort liability with respect to claims arising out of personal injury, death, or property damage, and which meets certain other requirements.<sup>237</sup> In the Government's view, Diamond had not met the economic performance test.<sup>238</sup>

The Federal Circuit allowed the taxpayer a deduction of \$23,339,417 for 1985.<sup>239</sup> The court stated that in 1985 the Group's liability to the individual claimants had merged with its liability to the settlement fund, as established by the settlement agreement.<sup>240</sup> Diamond could not be held liable in the future for additional

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228. *Maxus Energy*, 31 F.3d at 1142.

229. *Id.*

230. Tax Reform Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 494 (codified as amended at I.R.C. § 468B (1988)).

231. *Maxus Energy*, 31 F.3d at 1143.

232. *Id.* at 1142.

233. *Id.* at 1143.

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.* at n.22

238. *Id.*

239. *Id.* at 1144.

240. *Id.* at 1143.

amounts to claimants beyond the amount for which it was already liable.<sup>241</sup> Therefore, payment had been made to the "person" to whom Diamond was liable.<sup>242</sup> Because the Group's obligation to the injured class had been effectively discharged by the January 14, 1985 payment, the court concluded that economic performance had occurred.<sup>243</sup> The court further held that § 468B did not apply to the case.<sup>244</sup>

The question of the tax treatment of potentially responsible parties (PRPs), with respect to settlement fund payments, is currently of keen interest to the IRS. The IRS is principally concerned with the deductibility of payments to these funds, and the subsequent tax treatment of income earned on them. Section 468B, which deals with designated settlement funds, was enacted in 1986 as part of the Tax Reform Act of 1986.<sup>245</sup> Section 468B provides that qualified payments to a designated settlement fund, which extinguish a taxpayer's tort liability, constitute economic performance with respect to that liability.<sup>246</sup> Thus, an accrual basis taxpayer may deduct qualified payments to a fund in the year those payments are made.

Section 468B and the IRS are focusing on environmental cleanup funds under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).<sup>247</sup> In many cases, the PRPs making contributions to an environmental settlement fund will remain liable for additional payments if earlier deposits into the fund are insufficient to complete the cleanup.<sup>248</sup> In order for PRPs to claim immediate deductions for contributions made into the fund, the IRS requires the PRPs to receive a release from the Environmental Protection Agency.<sup>249</sup>

At the 1994 annual meeting of the American Bar Association's Tax Section, an IRS spokesperson described the Federal Circuit's decision

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241. *Id.* at 1144.

242. *Id.*

243. *Id.* at 1145.

244. *Id.* at 1144. The court found that because the settlement in this case is of a contested liability within the express terms of I.R.C. § 461(f), the provisions of § 468B are inapplicable. *Id.*

245. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified at I.R.C. § 468B (1988)).

246. I.R.C. § 468B (1988). Specifically, § 468B states that "economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund." *Id.*

247. 42 U.S.C. §§ 9601-9675 (1988).

248. *See Missouri v. Independent Petrochem. Corp.*, 610 F. Supp. 4, 15 (E.D. Md. 1985) (discussing liability of defendants releasing hazardous waste under CERCLA).

249. *See* Ellen Rosenthal, *IRS, Environmental Tax Practitioners Debate Timing, Classification Issues of Settlement Funds*, 94 TNT 158-67 (Aug. 12, 1994) (discussing tax treatment of environmental settlements, and timing of deductions for contributions to those funds).



in *Maxus Energy* as “a little problematic” and “troubling” under § 461(h) because the deduction was allowed even though the fund was a contested liability fund.<sup>250</sup>

#### X. COLLATERAL ESTOPPEL

Arkla sold natural gas which it maintained in the Chiles Dome Reservoir, a natural underground reservoir.<sup>251</sup> Arkla determined that in order to maintain sufficient pressure in the reservoir to retrieve the gas, it needed at least 14 billion cubic feet (BCF) of “cushion gas,” which creates the necessary pressure for pumping.<sup>252</sup> Some of the cushion gas was recoverable and some was nonrecoverable.<sup>253</sup>

The IRS allowed Arkla to claim an investment tax credit (ITC) for the cost of the nonrecoverable portion of the gas on its 1980 tax return.<sup>254</sup> Subsequently, Arkla filed an amended return, claiming an additional ITC for the recoverable portion of the cushion gas, and seeking a tax refund.<sup>255</sup> The IRS did not respond favorably to the claim, and Arkla brought a refund suit in the District Court for the Western District of Louisiana.<sup>256</sup> The district court held for Arkla, but the Fifth Circuit reversed,<sup>257</sup> holding that the recoverable gas was not depreciable and did not qualify for an ITC because it did not have a measurable useful life. The gas would remain physically unchanged in the well for the indefinite future, and could be recovered and sold when Arkla closed the reservoir.<sup>258</sup>

Arkla again claimed an ITC for cushion gas in the 1981 tax year, as well as a depreciation deduction under the Accelerated Cost Recovery System (ACRS).<sup>259</sup> Arkla also claimed similar deductions and credits for gas purchases on its 1982, 1983, and 1984 returns.<sup>260</sup> The IRS

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250. *Id.*

251. *Arkla, Inc. v. United States*, 32 F.3d 621, 622 (Fed. Cir. 1994).

252. *Id.*

253. *Id.* Both recoverable and nonrecoverable cushion gas serve the same function in operating a gas storage facility, but only recoverable cushion gas can be economically withdrawn from the reservoir and sold upon abandonment of the facility. *Id.*

254. *Id.* at 622-23.

255. *Id.* at 623.

256. *Id.*

257. *Arkla, Inc. v. United States*, 592 F. Supp. 502 (W.D. La. 1984), *rev'd*, 765 F.2d 487 (5th Cir. 1985), *cert. denied*, 475 U.S. 1064 (1986).

258. *Arkla*, 32 F.3d at 623 (concluding that I.R.C. § 48(a)(1) required gas to be depreciable capital asset and have useful life of more than three years in order to qualify for investment tax credit).

259. *Id.* at 623.

260. *Id.*

disallowed each of these deductions and credits.<sup>261</sup> Because Arkla had lost the issue for its 1980 return in the Fifth Circuit, it brought suit with respect to the 1981-84 years in the Claims Court.<sup>262</sup>

The Claims Court relied on collateral estoppel in holding for the Government and the Federal Circuit affirmed,<sup>263</sup> stating that collateral estoppel barred Arkla from relitigating the issues presented to the Fifth Circuit because the law and material facts were identical in both cases, despite the fact that the subsequent Federal Circuit case involved different tax years.<sup>264</sup>

The Federal Circuit's decision is consistent with those of other courts that have invoked collateral estoppel to prevent repeated litigation of the same issues.<sup>265</sup> Where there has been a significant intervening change with respect to the legal basis of an earlier decision, such as a Supreme Court decision, collateral estoppel is inapplicable.<sup>266</sup> Although the taxpayer in this case argued that legal principles had changed since the earlier judgment had been handed down,<sup>267</sup> the Federal Circuit concluded that the Fifth Circuit had completely addressed the issue and held that the doctrine of collateral estoppel applied.<sup>268</sup>

## XI. FOREIGN TAX CREDIT

Under British law, a resident corporation must pay an Advance Corporate Tax (ACT) on qualifying shareholder distributions.<sup>269</sup> Unlike the United States, which imposes double taxes on corporate income, the U.K. has an "integrated system" with dividend relief, but imposes an advance corporate tax on distributions to insure that the tax is paid at least once.<sup>270</sup> The corporation may use its ACT payments to offset its mainstream corporate tax, but the ACT is payable whether or not the corporation has turned a profit.<sup>271</sup>

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261. *Id.*

262. *Id.*

263. *Id.* at 625.

264. *Id.*

265. *See* *Lea, Inc. v. Commissioner*, 69 T.C. 762, 770 (1978) (stating that taxpayers are collaterally estopped from relitigating issues when controlling facts and legal principles are same).

266. *Commissioner v. Sunnen*, 333 U.S. 591, 599-600 (1948) (holding collateral estoppel inapplicable where legal principles have significantly changed since judgment of same issue under identical facts in earlier case).

267. *Arkla v. United States*, 37 F.3d 621, 625 (Fed. Cir. 1994).

268. *Id.*

269. *See* *Xerox Corp. v. United States*, 41 F.3d 647, 649 (Fed. Cir. 1994).

270. *See id.* at 649-50 (discussing corporate taxation in United Kingdom).

271. *Id.*

While the tax is nonrefundable, it is subject to a two-year carryback and unlimited carryforward.<sup>272</sup>

Rank Xerox, Ltd. (RXL) is a British corporation, the majority of whose stock is owned by Xerox Corporation (Xerox), a United States corporation.<sup>273</sup> In 1974, RXL distributed dividends to Xerox and paid ACT tax on the distributions, as required by British law.<sup>274</sup> RXL used part of its ACT payments to offset 1974 corporation income taxes owed to the United Kingdom.<sup>275</sup> Xerox claimed a foreign tax credit in 1974 for its ACT payments to offset its U.S. tax, pursuant to the United States-United Kingdom Tax Treaty (U.S.-U.K. Tax Treaty).<sup>276</sup> This treaty permits U.S. companies to claim foreign tax credits for ACT payments made to the U.K. in order to eliminate double taxation on earnings of a U.K. company.<sup>277</sup>

In 1980, RXL surrendered its unused ACT carryforwards to its British subsidiaries, a transaction specifically permitted under British law.<sup>278</sup> Once RXL did so, however, the IRS concluded that Xerox should not have been allowed to claim 1974 foreign tax credits with respect to the surrendered carryforwards, and sought additional taxes from Xerox in connection with the company's 1974 dividend income.<sup>279</sup>

Xerox paid the additional tax and brought a refund suit in the Claims Court, which denied Xerox's claim.<sup>280</sup> The Federal Circuit, however, in a holding that may cost the Government millions of dollars in tax revenues, reversed the Claims Court and allowed the foreign tax credit to Xerox.<sup>281</sup> The court held that, under the U.S.-U.K. Tax Treaty, the ACT is fully creditable by a U.S. company when paid or accrued in the United Kingdom.<sup>282</sup> As a consequence, RXL's subsequent surrender of its ACT carryforwards to its British subsidiaries (and thereby the right to offset the ACT against future corporation income) did not reduce the foreign tax credit available to its U.S. shareholders.<sup>283</sup>

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272. *Id.*

273. *Id.* at 649.

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.*

278. *Id.*

279. *Id.*

280. *Id.*

281. *Id.* at 660.

282. *Id.*

283. *Id.*

The Government argued that the U.S.-U.K. Tax Treaty permits the United States to withdraw the foreign tax credit if the ACT is not set off against the British company's U.K. mainstream corporation tax.<sup>284</sup> The Federal Circuit, however, held that the allowance of the foreign tax credit under the treaty was not so limited. Xerox was therefore entitled to the credit in 1974, when RXL distributed dividends and paid ACT on those distributions.<sup>285</sup> Once Xerox became entitled to the credit, it was not defeasible based on whether or how RXL applied the ACT offset, or whether RXL had surrendered its rights to its subsidiaries under British law.<sup>286</sup>

The IRS may well decide to appeal the Federal Circuit's decision to the U.S. Supreme Court because of the amount of revenue involved. The problem the Government will face in getting a grant of certiorari is the lack of conflict among the circuits regarding the status of the Act and the foreign tax credit.

## XII. PUERTO RICAN WITHHOLDING AGREEMENT INVALID

In 1988, the U.S. Secretary of the Treasury and the Puerto Rican Government entered into an agreement<sup>287</sup> allowing the United States to withhold Puerto Rican income tax from the wages of federal employees working in Puerto Rico.<sup>288</sup> In 1989, a class of employees brought suit against the United States in the District Court of Puerto Rico, seeking declaratory and injunctive relief, and back pay in the amount they alleged was unlawfully withheld.<sup>289</sup>

The district court found the agreement valid, and the employees appealed to the First Circuit.<sup>290</sup> Without rendering a decision, the First Circuit determined that the employees' claims were non-frivolous and, pursuant to the Little Tucker Act,<sup>291</sup> transferred the case to the Federal Circuit.<sup>292</sup>

The Federal Circuit reversed the district court and remanded the case,<sup>293</sup> stating that 5 U.S.C. § 5517(c) authorized the Secretary of

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284. *Id.* at 652.

285. *Id.* at 660.

286. *Id.*

287. See *Romero v. United States*, 38 F.3d 1204, 1206 (Fed. Cir. 1994) (granting Secretary of Treasury power to enter into federal withholding tax agreements with states). This agreement was entered into under 5 U.S.C. § 5517 (1994). *Id.*

288. *Id.*

289. *Id.* at 1207.

290. *Id.*

291. Little Tucker Act, 28 U.S.C. § 1346(a)(2) (1988) (stating that where district court's jurisdiction is based in whole or in part on non-frivolous claim, exclusive jurisdiction of appeal lies in that court).

292. *Romero*, 38 F.3d at 1207.

293. *Id.* at 1212.

the Treasury to enter into withholding agreements only with states, territories, or possessions of the United States.<sup>294</sup> Puerto Rico, a Commonwealth, is none of these.<sup>295</sup> Accordingly, the court held the withholding agreement unlawful and void.<sup>296</sup>

With respect to the employees' action for back pay, the court declined to hold the United States liable for monies previously given to Puerto Rico under the withholding agreement.<sup>297</sup> It did, however, order the United States to refund withheld funds that had not yet been paid to Puerto Rico.<sup>298</sup>

### XIII. VALUATION

The Federal Circuit was called upon to decide a valuation dispute in *Hearst Corp. v. United States*.<sup>299</sup> *Hearst* involved a charitable contribution made by the Hearst Metrotone News Film Library to the University of California at Los Angeles (UCLA) in four installments—one each in 1981 and 1982, and two in 1985.<sup>300</sup> Hearst claimed \$62,000,080 in tax deductions for these years. The IRS, however, valued the gift at only \$1,847,844—more than \$60 million less than Hearst's figure.<sup>301</sup>

Both the taxpayer and the Government utilized two expert witnesses to estimate the value of the gift.<sup>302</sup> The Claims Court found no expert persuasive, however, for reasons including what the court saw as reliance on noncomparable sales and highly speculative and optimistic assumptions.<sup>303</sup> The Claims Court also determined that all four gifts were part of a single donative plan, and that, under the step transaction doctrine<sup>304</sup> all four gifts should be treated as a single transaction valued on the date of the first transfer, December 2, 1981.<sup>305</sup> The Claims Court then determined that because the IRS' valuation was presumptively correct, and the taxpayer had failed

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294. *Id.*

295. *Id.*

296. *Id.* at 1210.

297. *Id.* at 1212.

298. *Id.*

299. No. 93-5160, 1994 U.S. App. LEXIS 25788 (Fed. Cir. Sept. 15, 1994).

300. *Hearst Corp. v. United States*, No. 93-5160, 1994 U.S. App. LEXIS 25788, at \*1 (Fed. Cir. Sept. 15, 1994).

301. *Id.*

302. *Id.* at \*3-4.

303. *Id.* at \*5.

304. See *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969) (characterizing step transaction as integrated transaction not broken into independent steps when attaching tax consequences).

305. *Hearst Corp.*, 1994 U.S. App. LEXIS 25788, at \*5.

through its experts to rebut the presumption, the asserted deficiency should be upheld.<sup>306</sup>

The Federal Circuit reversed.<sup>307</sup> Unlike the Claims Court, the Federal Circuit found that the transactions in issue were distinct transactions and thus, the Claims Court should have considered the four valuation dates.<sup>308</sup> The Federal Circuit also disagreed with the Government's attempt to characterize the step transaction approach applied by the Claims Court as harmless error.<sup>309</sup> It stated that the Claims Court had rejected the taxpayer's experts for a variety of reasons, including the fact that the experts had considered market events after 1981.<sup>310</sup> The Federal Circuit stated that the step transaction approach utilized by the Claims Court "infected the trial court's view of the case in all aspects."<sup>311</sup> Accordingly, the only appropriate disposition was to remand the case for reconsideration based on a valuation in accordance with the court's opinion.<sup>312</sup>

#### CONCLUSION

In 1994, the Government prevailed in twelve tax cases and the taxpayers in four. If the scorecard were kept in terms of numbers of wins and losses, it was a good year for the Government. On the other hand, if the measure of governmental success in 1994 is dollar amounts won and lost, the Government fared significantly less well in 1994. Between *Xerox*, *Romero*, and *Hearst*, taxpayers were successful in keeping hundreds of millions of dollars out of the Government's hands. In addition, *Maxus Energy* may pose significant future problems for the Government with respect to the deductibility of large environmental settlement contributions. As in prior years, the Federal Circuit can certainly be said to have left its mark on the development of the tax law.

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306. *Id.*

307. *Id.* at \*8.

308. *Id.* at \*12.

309. *Id.* at \*9.

310. *Id.* at \*11.

311. *Id.* at \*12.

312. *Id.*