1986

Over the Back Fence: Tax Shelters and Other Sales of Federal Income Tax Reductions

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OVER THE BACK FENCE: TAX SHELTERS AND OTHER SALES OF FEDERAL INCOME TAX REDUCTIONS

by

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INTRODUCTION

STRUCTURAL FEATURES OF the federal income tax system frequently make the same tax reduction[1] more valuable to one taxpayer than to another.[2] There are many types of such tax reductions (including deductions and credits), creating a fertile environment for the tax shelter markets. Black letter law says tax reductions are nontransferable. In other words, taxpayers are not allowed to sell their mortgage interest deductions over the back fence to their neighbors. Yet, observation reveals some transactions where tax reductions are in effect bought and sold.[3] This article will examine four of these transactions: business sales, divorce agreements, sale-leasebacks, and partnership

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[1]I have used the term "tax reduction" because it does not have the connotations associated with "tax benefit" and is a broader term than "tax deduction." The term "tax reduction" can have either a narrow or broad meaning. Unless otherwise indicated, I am using the term in its narrow sense. Narrowly, a tax reduction is a tax-significant condition, either status or event, which when reported on a tax return for a particular year *does* reduce the taxes of the person reporting it in the year of its transfer. In addition, a tax reduction *may* reduce taxes in other years, either past or future. The cases implicitly draw this distinction, sanctioning tax reduction sales which may possibly reduce taxes in future years rather than those which surely reduce current taxes. *Compare* Frank Lyon Co. V. United States, 435 U.S. 561, 580 n. 15 (1978) (sale leaseback held proper by the Supreme Court, noting that the favorable tax consequences were not certain) with Kresser v. Comm'r, 54 T.C. 1621 (1970) (last minute shuffling of partnership income which was certain to produce favorable tax consequences in the year of transfer held invalid).

[2]For illustration of a conceivable sale of a tax reduction, assume unrelated taxpayers were able to file joint returns, and a Mr. Rich and Mr. Poor were matched through a national exchange. Assume Mr. Rich's $50,000 of income and Mr. Poor's zero income could be reported, for tax purposes only, as $25,000 of income each. After Mr. Rich pays the "joint return's" taxes, there would be about $5,000 of tax savings, due to the income tax's progressive rates, which the two could split between them, computed as follows. Federal income taxes before credits on zero taxable income is zero, on $25,000 of taxable income is about $5,000, and on $50,000 of taxable income is about $15,000. I.R.C. § 1(c)-(3) (1984). Before the tax benefit sale, Mr. Rich owes about $15,000 of pre-credit tax, and Mr. Poor owes nothing. After the sale, by filing jointly, in effect Mr. Rich and Mr. Poor both owe $5,000, effectively reporting $25,000 each, for a total of roughly $10,000. I.R.C. § 1(a)(3) (1986). The sale produces a tax savings of $5,000. Mr. Rich of course pays the joint taxes. The possibility of extra income to Mr. Poor by being relieved of this obligation is ignored. If this type of sale were allowed, Mr. Poor would have in effect sold (or rented) his low-bracket rates to Mr. Rich. This sale is different from a gratuitous assignment of income within families, where the transferor is a net loser. Mr. Rich is not giving Mr. Poor anything. They may not even know each other. The sale occurs because the tax reductions are more valuable to Mr. Rich than Mr. Poor. After the sale both parties are better off, at the expense of the Treasury which in effect contributes the extra value. Of course, unrelated taxpayers are not able to file joint returns, but see the delicious tongue-in-cheek anticipation of "Budget Rent-a-Spouse." Blum & Pedrick, *Taxation for Prosperity? Some AILJ Views on ERTA '81,* 60 TAXES 92, 95-96 (1982).

The stakes, that is the potential revenue loss from tax benefit sales, is large in absolute if not relative terms. The safe-harbor leasing provisions specifically authorized by the Economic Recovery Tax Act of 1981 cost approximately $3 billion in 1981-82 taxes.

[3]*See, e.g.,* 95-4th TAX. MAGMT. (BNA) A-1 (1986) ("The law allows the spouses vast choice in allocating the tax burdens between them.") (discussing the pre-1985 law) and Weidner, *Partnership Allocations & Tax Reform,* 5 FLA. ST. U. L. REV. 1, 64 (1977) ("[I]t is extremely common for partners to attempt to allocate tax benefits and burdens differently than they allocate cash benefits and burdens . . . . Depreciation deductions and the tax losses they produce are viewed as commodities to be bartered among partners . . . .")

special allocations.[4]

Close observation of these four transactions yields intriguing connections. For example, just as the sources of yellow fever can be traced to swamps, sales of tax reductions, including tax shelters, can be traced to ambiguous sections of the Internal Revenue Code. How quickly these areas receive attention is the subject of another discovery. There appears to be a significant difference between the perceived and the actual federal income tax system. The forces of reform seem to be stirred into action primarily by threats to the perceived, not the actual, tax system.

The central problems of the first pair of transactional areas, business sales and divorce agreements, are quite different from the second pair, sale-leasebacks and partnership special allocations. The distinction is that in the first pair, the tax reductions can be marketed only to the other person in the transaction. But in the second, multiple parties may receive the reductions.[5]

The first pair of transactions is best suited for a discussion of the administrative problems which breed sales of tax reductions. Accordingly, the next segment of this article, will examine the first pair. Normally a fact-pattern's "substance" determines its tax classification. However, where the classifications are ill-drawn and ambiguous, another method of classification must be used. The one most frequently employed is "parties' choice,"[6] which allows the parties to choose those classifications which result in the least aggregate tax.

The second pair of transactions raises issues concerning tax shelters. Tax shelters appear to be objectionable not because they threaten the actual federal income tax system,[7] but because they threaten the *perceived* federal income tax system.[8] It is the marketing of tax shelters which appears to be the real

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[4]Other transactions involving the transfer of tax reductions will not be examined, for example, I.R.C. § 381(a), (c)(1) involving carryovers of net operating losses. *See also* Tax Reform Act of 1984 (Division A of Deficit Reduction Act of 1984) Pub. L. No. 98-369, 31, 98 Stat. 494 (1984) (curbing tax-exempt leasing abuses).

[5]While no national exchange market expressly matches tax reduction buyers and sellers, the parties which would be attracted to such a market are readily identifiable. Tax reduction "sellers" would generally be low or zero-bracket taxpayers including; tax-exempt organizations, qualified pension trusts, municipalities, taxpayers with large depreciation deductions or loss carryovers, and, all too frequently, divorced women. Any taxpayer in a bracket lower than the top marginal bracket is a potential tax-reduction seller. *See* Brown v. Comm'r, 37 T.C. 461 (1961) (corporate bail-out allowed through "sale" to a tax-exempt organization). Tax reduction "buyers" obviously would generally be high-bracket taxpayers.

[6]This is my term.

[7]The relative tax brackets of the parties and potential loss in government revenues are rarely considered in tax reduction cases. More typical is the judicial hostility expressed in a leasing arrangement.

> We do not criticize the commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowances for depreciation, which he concedes, and an allowance for interest, the attack on many of the "leases" may not be worthwhile in terms of revenue.

Estate of Starr v. Comm'r, 274 F.2d 294, 296-97 (9th Cir. 1959) (proported "lease" held actually a "sale" for tax purposes).

[8]Some rough computations might put the potential for these transactions in perspective. The total

harm. This article explores various solutions to this problem.[9]

I. THE ADMINISTRATIVE PROBLEM AND THE "PARTIES' CHOICE" METHOD OF TAX CLASSIFICATION

A. *Methods of Analysis*

By what means do we validly criticize the federal income tax system? One method is to determine what *is* happening and then compare it with what we believe *should* be happening. This comparison takes place on two levels: (1) with what is happening as taxpayers attempt to avoid taxes and (2) with what is happening in those judicial resolutions of the resulting disputes with the Treasury.[10] Prior to examining the first pair of transactions below, it will prove useful to briefly sketch out an underlying theory of what appears to be happening in tax classification generally.

Without too much distortion, the present structure of the federal income tax can be seen as a computational system. Perceived facts, or more pedantically, "fact patterns," from the real world are translated into defined terms[11] and thereby imputed into the tax system.[12] Internal logic operators then compute the tax due, usually to an exact dollar amount. Sometimes, as with the four transactions examined here, the classification system does not work well. The same fact pattern can be classified into either of two competing definitions, leading to different tax results for the parties engaged in the transaction. When this happens, tribunals can not decide classification disputes by using the fact pattern's "substance" and must turn to some other classification method to resolve the dispute before it. As mentioned, the most common alternate is

depreciable, depletable, and amortizable assets in place and newly acquired in 1980 was about $2 trillion. Apart from the investment tax credit, the deductions for depreciation, depletion and amortization were about $200 billion in 1980.

The potential market of individuals for these reductions is less than the amount of reductions that exist. I.R.C. § 1(a)(3) (1986) provides that persons with taxable incomes of more than approximately $100,000 pay about 50% in federal income tax for every dollar earned. The aggregate taxable income of taxpayers in this bracket is about $100 billion dollars. (These are the figures for individual income and do not include corporate income, but should provide some rough figures of the size of the potential demand for tax reductions.) A paper allocation of about half of the 1980 annual depreciation to high-bracket individuals (without other tax sections) would completely eliminate federal income tax for those high-bracket individuals. The loss in the Treasury's revenue would be minimal, about 5% of the 1980 budget. Without public disclosure, the effects on the actual tax structure would also be minimal. Nevertheless, the general knowledge that anyone earning over $100,000 a year can escape tax entirely would be a serious blow to the taxpayers' perception of the tax system's fairness, undermining the essential element of efficient self-assessment.

[9] Approximately 15% of the tax reductions sold in the congressionally sanctioned, safe-harbor sale-leasebacks went to lawyers, accountants and brokerage firms, about the same order of magnitude as promoter fees in the partnership special allocation area. Unlike real estate tax shelters, sale-leasebacks did not have time to reach all individuals. Elimination of controls on sales of tax reductions (including, but not limited to sale-leasebacks) would create about a $750 million tax shelter industry.

[10] For convenience, the term "Treasury" will generally be used herein to refer to any of that department's many branches and administrative titles, since precision will often detract from the flow of the text. "Secretary" will refer to the Secretary of the Treasury, "Commissioner" will refer to the Commissioner of Internal Revenue, and "Service" will refer to the Internal Revenue Service, a branch of the Treasury.

[11] Such as "gross income," "interest," "gift," etc.

[12] Perception already classifies to some degree. The Russian words goluboy (light blue) and siniy (dark blue) break up the "blue" part of the light spectrum in different ways than English, presumably coloring the ways in which a Russian perceives his world.

"parties' choice," where the parties agree on the classification. If the parties' situations are such that one of the two competing classifications will lower the taxes of one party more than it will raise the taxes of another party, the stage is set for a possible sale of a tax reduction.

Take the example of a soon-to-be-divorced high earning husband and his nonworking wife. There is usually some flexibility in whether these two parties classify future cash payments from him to her as "alimony" or "child support." As will be seen in more detail later, by choosing "alimony" as the classification of the payments, the parties in effect allow dollars earned by the husband to be taxed more lightly by employing the wife's under-used lower tax brackets. If she is alert, she will exact a price for the use of her lower tax brackets. In theory, the price should involve more dollars than she would have received without her agreement to the classification choice, but the additional amount should be less than the tax savings realized by her husband. The tax savings to both parties can be substantial. It should be obvious that if the classification of the fact pattern were clear, the tribunal would not need the "parties' choice" method of classification and would deprive the parties of the opportunity to make a tax reduction sale.

Once we find out what is happening, both in the tax avoidance transactions which lead to tax disputes and in the judicial resolution of those disputes, we need to evaluate whether what *is* happening squares with what *should* be happening. From what perspective do we evaluate the tax system? What norms do we employ?

One normative approach already mentioned is to criticize the actual system by comparison with an ideal one. For example, since there appears to be no good reason why transfers of property at death should be treated differently than transfers of property by gift, an ideal federal income system would treat them both alike.[13] There are almost as many idealized models as there are observers, and this approach suggests many avenues of tax reform.

A second approach is political. No ideal model can adequately capture all of the lives and all of the transactions affected by the tax system,[14] which, after all, is both the creation of our political process and is ultimately judged by it.[15] Unfortunately, the political process is better at reacting to suggested change than initiating it. There may be no political pressure to make a change which could improve the tax system, or there may be political pressure to change a

[13] I.R.C. §§ 1014 and 1015 (1986) (carry over basis for transfers by gift, "step up" in basis for transfers by death).

[14] It has been said that much of the economics underlying the tax system is difficult, even impossible, to discover. B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS (1981).

[15] The federal income tax system is the result of social preferences revealed and effectuated through a political system which encompasses the tax system. L. EISENSTEIN, THE IDEOLOGIES OF TAXATION (1961) Social preferences at a particular time may be directly accessible. *See* Harstad, *Interpreting American's Attitudes Toward Taxes*, TAX NOTES, Nov. 9, 1981 at 1083 (opinion polls indicating social preferences).

system that cannot be improved.

These two normative approaches can be synthesized, drawing the best from each, by using an experimental approach: try it and see if it works. Ideal models can suggest avenues for reform which can be evaluated politically. When Code Section 1023 was enacted in 1976[16] to bring the tax treatment of gratuitous property transfers at death into line with those during life, the change suggested by the ideal tax model did not work. After delaying the change's implementation for three years, Section 1023 was repealed.[17]

Since these are basically governmental processes, the interest of the organization may play an important, even dominating, role. Indeed, when one attempts to filter out the interests of the two main tribunals, the courts and the Treasury, there may not be much left from which to draw normative conclusions.

B. *Self-Limiting Sales of Tax Reductions: Business Sales & Divorce Agreements*

Turning to the cases, the opportunity for a sale of a tax reduction arises when the events in a transaction can, with validity, be channeled into more than one classification with different tax results to the parties. This section looks at two such transactions which serve to illustrate the genre: business sales and divorce agreements. In addition to having ambiguous classifications in common, these two also share another characteristic which distinguishes them from the second pair previously discussed. These two are self-limiting; that is, the players are limited by the nature of the transaction.[18]

The major arbitrators in these two transactions are the courts and the Treasury. The differing standards they have adopted lead to considerable but characteristic confusion. In most cases, the best solution is congressional amendment to tighten the tax classification.[19] The next best solution is allow-

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[16]Tax Reform Act of 1976, Pub. L. 94-455 § 2005, 90 Stat. 1872.

[17]Windfall Profit Tax Act of 1980, Pub. L. 96-223, § 401.

[18]In divorce agreements, the parties must have been married to each other. In business sales, the seller must have a business to sell.

[19]While it is not the primary purpose of this article to suggest how Congress should act, some general principles may provide guidance. A principle of horizontal equity states that transactions which are alike should have the same tax consequences. This principle is violated if the parties can decide which of two classifications to use, leading to different tax results. Congress can either refine the categories to limit this freedom of classification, *e.g.*, H.R. Conf 861, 98th Cong., 2d Sess. 1497 (1984) (tightening the categories for divorce agreements), or it can make the tax consequences of the two categories, such as "covenants not to compete" and "goodwill," the same. *See* Beghe, *Income Tax Treatment of Covenants Not to Compete, Consulting Agreements and Transfers of Goodwill*, 30 TAX L. 527, 623-24 (1977 (where the possibility that this has been done by judicial action is suggested).

Neat solutions are sometimes not possible, such as where the potential fact patterns are diverse and have to be fit into all-or-nothing tax categories. Unfortunately for those cases, the tax system is not yet sophisticated enough to provide sliding tax categories with sliding tax consequences. Except for "parties' choice" divorce payments cannot yet be classified as 25% child support and 75% alimony. However, in other areas it is possible to alter the sytem.

ing the Treasury to make the decisions in ambiguous classifications, expressly allowing "parties' choice" in those situations open only to a limited number of players.[20] However, sometimes neither option is open, and a court must resolve the classification dispute.

1. Business Sales

The first transaction is the sale of a business, often a small closely-held proprietorship selling out to a chain. The chain purchases various assets such as real estate, fixtures, and inventory.[21] The chain also purchases two other assets which are difficult to value, goodwill and a covenant (from the seller) not to compete,[22] thus creating an opportunity for tax reduction sales. The amount paid in excess of the market value of the business assets can usually be allocated either to goodwill or to the seller's covenant not to compete.[23] This allocation leads to different tax consequences for the seller[24] and the buyer.[25]

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[20]*See supra* note 5.

[21]*See, e.g.*, Schwartz v. Comm'r, 29 T.C.M. (P-H) ¶ 60,228 (1960) (goodwill, fixtures and equipment).

[22]The seller gives a covenant not to compete, usually within a specific geographic area and for a limited time. A consulting contract might also be part of the package.

[23]The allocation may have some effect on the damages which may be collected for a violation of the covenant under state law and some effect on the balance sheet. In any event, these considerations are frequently minor. The holder of the covenant will often want an injunction rather than money damages to protect his purchased business, and a sophisticated reader of balance sheets will not be swayed by a difference in allocation. But see *Frank Lyon Co., supra* note 1, where the fact that debt was listed on the company's balance sheet was important to the Supreme Court.

[24]The seller is generally taxed at capital gains rates for the depreciable and nondepreciable assets in the business sold (the buyer then takes the market value as his basis for each asset). As to goodwill, the seller is taxed at capital gains rates. Davee v. United States, 444 F.2d 557 (Ct. Cl. 1971) (sale of an unincorporated market research publication). This gain has the additional advantage of not being allocated to a nondepreciable asset, avoiding any potential recapture as ordinary income as might be on amounts allocated to depreciable assets. *See* I.R.C. §§ 1245 and 1250 (1984). Therefore, if the price is set the seller will want as much allocated as possible to this asset.

As to the covenant not to compete (or a consulting contract), the seller is taxed at ordinary income rates for amounts allocated to these assets. These assets represent a personal contractual agreement to forebear from an otherwise allowed course of action. Beals' Estate v. Comm'r, 82 F.2d 268 (2nd Cir. 1936) (stock received by officers of selling corporation for covenant).

From a tax standpoint allocations to a "consulting contract" appear to offer many of the same tax effects as a covenant not to compete, including a deduction to the buyer and ordinary income to the seller. Balthrope v. Comm'r, 356 F.2d 28 (5th Cir. 1966) (undifferentiated amount allocated to covenant and consulting services). At present, one might be concerned about subjecting the payments to Old Age, Survivors, and Disability Insurance (I.R.C. §§ 3101(a) and 3111(c); 5.7% on wages for both employee and employer through 1987) and to Hospital Insurance (I.R.C. §§ 3101(b) and 3111(b); 1.45% to both after 1985)). With a total of 14.3% on a greatly expanded wage base, the scale tips toward covenants not to compete. *Davee*, 444 F.2d at 557.

[25]The allocations are made to the various business assets. Most of the assets have a measurable value with a resulting fairly straightforward taxation. The taxation of two other assets, goodwill and the covenant not to compete, are also straightforward. However, since they are unique assets, the amount allocated to each and the consequential taxes of the parties can vary. If the purchase price is set, the seller generally wants more allocated to goodwill, while the buyer wants more allocated to the covenant.

The buyer generally also takes the market value established by the parties for the goodwill. He can recover his basis only upon sale of the business. Goodwill, unlike the covenant not to compete, is nondepreciable.

As to the covenant not to compete, the buyer can amortize the covenant over its useful life and recover his investment as a deduction against ordinary income. Treas. Reg. § 1.167(a)-3(a) (1960). Presumably there is an argument that the covenant has a useful life different from its term. If the seller does not begin to com-

The allocation between goodwill and the covenant not to compete frequently benefits both parties at the expense of the Treasury.

Usually, the chain is in a higher marginal tax bracket than the seller. If all of the going concern premium is allocated to the covenant not to compete, the aggregate taxes paid by both parties is lower. This tax savings can be shared between them by an upward adjustment in the purchase price.[26] The opportunity for this deal arises because there is no easy way of determining the market value of either the goodwill or the seller's covenant not to compete. The response of the courts and the Treasury to this transaction will be considered in more detail later. In summary, if the parties report consistently (i.e., both allocate the same amount to goodwill or to the covenant), then the Treasury basically follows a "parties' choice" classification rule. The courts are more inclined to quest for an unknowable transactional "substance." Confusion results.[27]

2. Divorce Agreements

The second transaction is divorce and the allocation of periodic dollar

pete within the term, he probably will not compete. Therefore, the protection (it can be argued) really extends beyond the term. Besides being antithetical to the buyer's desires to write the covenant off quickly, this argument might lead to the covenant being nondepreciable. *See* J.I. Case Co. v. United States, 32 F.Supp. 754 (Ct. Cl. 1940).

[26] For illustration, suppose the premium is $5,000, the seller is retiring and will pay no taxes, and the buyer has enough other income that he is in the 50% marginal bracket. Assume further that $5,000 more or less won't change the tax brackets of either party. If they allocate $5,000 to the goodwill which the buyer is getting, the seller pays capital gains tax (of zero in this example but never more than 20%), and the buyer does not get any tax benefit until the business is sold. Goodwill is not depreciable. If, on the other hand, they allocate $5,000 to the covenant not to compete, then the seller has $5,000 of ordinary income (again zero tax in this example), and the buyer has an amortizable asset. He can amortize this $5,000 over five years and generate a $1,000 tax deduction worth $500 each year for those five years. The present value of this $500 saving each year is about $1802 (using a rough 12% inflation/interest assumption; and the effects of I.R.C. §§ 483 and 1274 (imputed interest) have been disregarded). If the seller is alert he will ask for about half of this savings in the form of a $900 higher price for the business. Frequently, neither he nor his counsel are alert.

[27] "[I]t takes no more than a cursory examination of the case law to disclose that the decisions in this area are in bewildering disarray." Prouix v. United States, 594 F.2d 832, 833 (Ct. Cl. 1979).

payments to alimony,[28] child support,[29] and property settlements.[30] Divorce payments are a fertile source of material for the present discussion. There is an illustrative contrast between the treatment of pre-1985 child support payments and property settlement payments; there is a contrast between poor and rich divorcers; and in 1984, Congress attempted to tighten the categories, providing a contrast between the law before and after January 1, 1985.

The reader will remember that one key characteristic of the divorce transaction which allows the Treasury to group it with business sales is the self-limiting nature of the transaction. Only parties who have been married can play, making it unsuitable for general tax shelter promotion.

Dollar payments are fungible and, prior to 1985, could be categorized with some flexibility as alimony, child support, or property settlement payments. The consequences of these classifications were different to the husband and wife. "Alimony" alone among the three potential categories is deductible to the husband and taxable to the wife. Thus, the opportunity for a tax reduction sale occurred when the husband's anticipated post-divorce marginal tax bracket was higher than his wife's. Therefore, within the general adversity

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[28] 1982 census figures indicate 15% of the 17 million divorced women were awarded alimony. 780,000 women were due alimony payments, the average amount of which was $3,000, and 43% received full payment. *See generally* BUREAU OF THE CENSUS 3, No. 124 (May 1982) (Advance Report Series) [hereinafter cited as ALIMONY 1981). Estimating for partial payments, which the survey did not catalogue, approximately $1.5 billion in alimony payments were reported paid in 1982. This matches closely with $1.4 billion alimony payments (317,335 returns) reported as income in 1979. 1980 TAX STATISTICS, Table 1.2. (It should be noted that the number of tax returns reporting alimony as income is about half of the census count of women receiving alimony. Furthermore, the average payment reported for tax purposes was greater, or about $4,500 per woman.)

Not surprisingly slightly more than half again as many ex-husbands (534,000) reported paying deductible alimony in more than half again the aggregate amount ($2.3 billion) reported by the women. 1980 TAX STATISTICS, Table 1.3. Women probably under-report more than men over-report so the actual alimony paid is probably about $2 billion.

The average male income was $13,110 in 1978 and $16,520 in 1980. CURRENT POPULATION REPORTS, SERIES P-60, No. 134 (table 12). The median income of never-divorced women was $8,141 in Spring, 1982. ALIMONY 1981, Table 4. The women's numbers are a somewhat deceptive guide to income subject to tax because the definition of income in the census survey included, among other things, social security, supplemental security income, public assistance, and child support. Average 1979 salaries and wages reported was approximately $9,000 for men and $7,000 for women. 1979 STATISTICS OF INCOME: INDIVIDUAL INCOME TAX RETURNS, TREAS. PUB. 79 (3-82) (hereinafter cited as 1979 TAX STATISTICS or 1980 TAX STATISTICS).

In 1985, the average husband's marginal tax rate was approximately 31% (I.R.C. § 1(c)(unmarried); the average woman's 17% (I.R.C. § 1(b) (head of household). The spread is 14%. (These are obviously rough figures but should provide some guidance). The spread obviously can be up to 50% and could have been more before the reduction in the maximum marginal rate to 50%. *Cf.* Wright v. Comm'r, 543 F.2d 593, (7th Cir. 1976) (husband was in the 70% marginal bracket).

If the Treasury contributes an average 20¢ per dollar, the greatest cost to the Treasury for sales of tax reductions in divorce agreements is about $400 million. This foregone revenue from tax reduction sales is .16% of the $250 billion in total income tax collected in 1980. 1980 TAX STATISTICS, Table A.

[29] Of the approximately 8 million women living with a child under 21 years, about 60% were awarded child support aggregating $10 billion due and $6 billion received ($2,000 average) for 1981. ALIMONY 1981 at 2. This is about three times the estimated alimony paid; *see* supra note 28. The stakes in characterization of child support, then, are probably about one half of one-percent of the total income tax collected.

[30] Of the 14.2 million never-divorced (not separated) women in Spring 1982, 40 percent were awarded a property settlement. ALIMONY 1981.

of divorce, there opened a zone of potential mutual cooperation.[31] If the parties allocated more than they ordinarily would have to alimony, the husband could take advantage of the wife's lower tax rates. Like business sale transactions, he shared this with her in the form of higher payments. Much of this is still true, but the new post-1985 law tightened the property settlement and child support categories, reducing both ambiguity and the consequential potential for tax reduction sales between divorcing husband and wife.[32]

C. *Resolving Difficult Tax Classification Cases In the First Pair of Transactions*

Neither the progressive rate structure, nor some form of hidden tax expenditure, adequately adds to a discussion of the "parties' choice" method of tax classification in hard cases. As to progressivity, the cases evidence little concern for the progressive rate structure in the actual federal income tax system.[33] This lack of concern will be explored in more detail. As to tax expenditures, while it is true that with its impenetrable hedge of jargon and numbers, the tax system is an ideal vehicle within which to hide tax expenditures.[34] Nevertheless, one can dismiss fairly quickly the suggestion that this explains why the "parties' choice" method of deciding difficult categorizations is allowed in business sales and divorce agreements. Not only does it seem bizarre to subsidize women with high-bracket former husbands, but well-counseled women as a group would do better if their former husbands could be assured that their wives could be held to their bargains.[35] Subsidizing business sales through this awkward method seems only slightly less likely. The business sale and pre-1985 property settlement cases indicate that this is not what was happening. Other reasons for using "parties' choice" must be found.

[31]This zone has been frequently overlooked by the parties. Schottenstein v. Comm'r, 75 T.C. 451, 457 (1980) (husband successfully reneges on his agreement: "the negotiations . . . were protracted, acrimonious, and an arms length"); Sydnes v. Comm'r, 68 T.C. 170, 172 n.2, *aff'd* 577 F.2d 60 (8th Cir. 1973) (the husband "stated to [wife's] attorney that under no circumstances would he pay or agree to pay any support, maintenance, or alimony. He also . . . stated . . . that he would leave the country before he would pay her one cent of alimony."); Bishop v. Comm'r, 55 T.C. 720, 726 (1971) ("These negotiations were protracted and bitter, and were accompanied by charges and counter-charges of infidelity and bad faith.").

[32]Title IV, §§ 411-492, 432 Pt. 2, 98th Cong., 2d Sess. 1497 P.L. 98-369 (1984).

[33]*See, e.g., Lester,* 366 U.S. at 299 (parties allowed to "fix" child support payments and thereby sell tax reductions); *Frank Lyon Co.,* 435 U.S. at 561 (sophisticated sale-leaseback involving a bank headquarters upheld). None of the cases read for this article directly discussed the progressive rate structure.

[34]*See* Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues,* 20 B.C.L. REV. 225 (1979). *See also* OFFICE OF THE MANAGEMENT & BUDGET, SPECIAL ANALYSIS G: TAX EXPENDITURES, THE BUDGET FOR FISCAL YEAR 1984. Tax expenditures should be (but usually are not) distinguished from tax incentives. The former divides the national pie. The later attempts to increase it. One of the reasons for allowing partnership special allocations was to allow sophisticated financing arrangements which might otherwise be inhibited, even if a price of allowing these arrangements was the sale of tax reductions. This is a tax incentive motive.

[35]Since it was often poor former wives who were before the court trying to avoid taxability of cash payments clearly labeled "property settlement," case law seems to have shifted toward allowing them to show the "substance" of the transaction and avoid taxability.

The best explanation for resort to the "parties' choice" method of tax classification is ease of administration by the courts and the Treasury. As the pre-1985 child support cases show, the "parties' choice" criteria has the advantage of deciding otherwise undecidable cases at relatively low cost. The tax results can be read from the parties' agreement.

The following discussion will look in more detail first at using a transaction's "substance" as a means of resolving difficult classification problems; second at "parties' choice" as an alternate means; and then, third, suggest another possibility.

1. Using a Transaction's "Substance" to Resolve Difficult Classification Issues

Courts are adept at classifying transactions according to their substance. That is, the court looks at the "substance" or "real nature" of the fact pattern offered as a candidate for a statutory definition and then at the configuration of the proffered statutory definition. Absent compelling policy reasons for denying or requiring statutory inclusion, the court uses the fact pattern's substance to determine its proper classification. With this general statutory approach, it is not surprising to find courts preferring to use this classification method in questionable tax cases.[36]

However, the "substance" method of classification breaks down when there are many difficult transactions to classify or when using a "substance" standard yields no results. In the divorce cases, there are well over one million divorces per year. Determining whether certain periodic payments are "property settlement" or "alimony," or whether business sales payments are attributed to "goodwill" rather than a "covenant not to compete" frustrated more than one pre-1985 court.[37] Sophisticated courts understand that sometimes classifying according to a transaction's "substance" simply does not work or does not work well.[38] Other methods must be used.

2. "Parties' Choice" as an Alternate Method

The "parties' choice" method is the alternate method most employed for

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[36] In the business sales area, Hamlin's Trust v. Comm'r, 209 F.2d 761 (10th Cir. 1954) is usually cited for the proposition that the substance of the allocation controls.

[37] "[T]he task of distinguishing between payments for support and payments for other marital rights [is] a virtually insurmountable one for the courts." COMMERCE CLEARING HOUSE, HIS, HERS OR THEIRS? FEDERAL INCOME TAXATION OF DIVORCE PROPERTY SETTLEMENTS 6 (1983) (prior to the 1984 changes). *See also* Beard v. Comm'r, 77 T.C. 1275 (1981) (property settlement case) praying for legislation to clean up the mess, a prayer mostly answered in Section 422(a) of the Tax Reform Act of 1984.

[38] *Lester,* 366 U.S. at 299 (Court abandons substance of "child support" for "parties' choice" standard); and *Frank Lyon Co.,* 435 U.S. at 561 (Court abandons substance for "parties' choice" in sophisticated sale-leaseback).

resolving disputes.[39] The "substance" method narrows the choices to the difficult ones; then, "parties' choice" is used to complete the classification.

As one might expect, the Treasury has been more liberal in adopting the "parties' choice" standard than the courts. This is shown in the quite different standards for business sales adopted by the two sorts of tribunals. With business sales, the Treasury is often willing to allow the form chosen by the parties to resolve disputes between them, holding them rigidly to their contractual allocation.[40] Its preferred standard, the "fraud" standard, allows the parties to challenge the tax consequences of the business sale agreement only on grounds which would allow state rescission of the contract, such as mistake, fraud, and duress.[41]

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[39]*Id. See also* Note, *Treatment of Covenants not to Compete: A Problem Purchase Price Allocation*, 67 YALE L.J. 1261 (1958) which makes the concluding argument that the parties be allowed to allocate freely between themselves in order to achieve predictability of result and save expenditures "for investigation and litigation on the question of true value." *Id.* at 1270.

[40]It is unclear from the cases how many consistently reported allocations are challenged by the Treasury since the cases usually do not indicate how the other party reported the transaction for tax purposes. O'Dell & Co. v. Comm'r, 61 T.C. 461 (1974) (Treasure loses) is the only case found by the author where the Treasury attacked a consistently reported business sales transaction. *Cf* Patterson v. Comm'r, T.C.M. (P-H) ¶ 85,053 (1985) (where the I.R.S. went after the seller of Long John Silvers and lost).

If the Treasury does not attack the allocation, who does? In business sales, the answer is the seller, who often finds out that he has unknowingly bargained away substantial tax benefits to the buyer. In divorce agreements, it is usually the former wife. Sale-leasebacks and partnership special allocations are invariably attacked by the Treasury, not the parties. There is even an amusing case where the Treasury urged more deductions on a taxpayer who resisted claiming any of them. Sellers v. Comm'r, 46 T.C.M. (P-H) ¶ 77,305, 77,308 (1977) (attorney-partner selling losses to his doctor-brother).

In business sales, the covenant may be patently specious. Nevertheless, the buyer has undoubtedly deducted his amortization for prior years, some of which may be closed under the 3-year statute of limitations. In this context, courts are torn between, on the one hand, holding the taxpayer to his form-over-substance bargain and violating the principle that the tax consequences follow from the substance of what was done, and on the other hand, following the substance-over-form principle and throwing the burden on the Treasury to catch the discrepancy quickly. *See* the conflict in *Danielson* between the majority and the dissent, *infra* note 49.

In divorce agreements, after initially challenging some of the "property settlement" reclassifications on the merits, the Treasury (but not the courts) apparently became less interested in determining whether a payment is in substance "alimony" or a "property settlement." It often takes the auditing position that the form of the transaction will be respected if reported consistently by the parties.

In cases where the Treasury is allowing "parties' choice," fairness to unsophisticated taxpayers suggests that the Treasury's position be spelled out in the regulations. *Cf.* Treas. Reg. § 1.1232-3(b)(2)(ii)(b) (providing when agreement as to reasonable allocation between bond and another part of an investment unit will be respected).

[41]Comm'r v. Danielson, 378 F.2d 771 (1967), vacating and remanding to the Tax Court, Danielson v. Comm'r, 44 T.C. 549 (1965), over the dissent of Chief Judge Stanley.

The facts of *Danielson* present almost no ambiguity as to what the Treasury and the Third Circuit intended with the new test. In purchasing the stock of a small loan company for $374 per share, the buyers allocated $152 per share to a covenant not to compete in an agreement signed by the sellers, most of whom had neither the inclination nor ability to compete. At the time of execution of the agreements, one of the [sellers] was a 93 year old retired businessman. He rarely left his home. Furthermore, his affairs were conducted by his wife. "Of the remaining [sellers], there were housewives with no knowledge of the small loan business . . . [One of the other remaining sellers] was in real estate and insurance work, residing and doing business some 60 miles beyond the area covered in the covenant. [The next to last seller] was a busy and successful surgeon." 44 T.C. at 557. Only one of the sellers was in a position to compete effectively. The buyer made no effort to evaluate and compensate him for his competition potential. Rather, the buyer carefully calculated the overall savings from allocating such a large portion of the purchase price to the covenant and passed much of this savings along to the sellers in the form of a higher price.

The general approach of the courts on business sales is different. After many muddled decades,[42] the Tax Court and all but one of the circuits adopted a doctrinally different "strong proof" standard, which is technically a procedural limitation; that is, tax consequences flow from the substance of the transaction. However, procedurally, the substance is shown by allocations in the contract unless the taxpayer can proffer "strong proof" that the contract

The sellers were told that there were some tax advantages to the buyers. However, they were not told that the price was higher because of the covenant nor the tax consequences to them. They did not understand the tax consequences of the agreement. The Tax Court found that the sellers had sustained their burden of "strong proof" that the allocations to the equation did not square with the substance of the transaction.

On appeal, the Third Circuit took the Treasury's form-over-substance approach and reversed. The test was somewhat narrower than that which the Treasury was urging in the Tax Court. The test announced by the Third Circuit (and never adopted beyond that circuit) was: "A party can challenge the tax consequences of his agreement as construed by the Treasury only by aducing proof which in an action between the parties to the agreement would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc."

A misunderstanding of law is generally not a sufficient ground for rescission. The law is available for everyone to know. The intent here is to require the seller to take the more burdensome step of suing the buyer to make himself whole without involving the Treasury in the dispute.

As stated, the "rule" is one sided and leaves open an attack by the Treasury (but not the parties) on the contractual allocation. The Tax Court opinion clearly indicates that the Treasury was arguing for a broader rule more like *Lester*, 366 U.S. 299 (holding the parties have absolute right to "fix" child support without fear of attack by the Treasury). *Danielson*, 44 T.C. at 555.

In arriving at the *Danielson* rule, the Third Circuit believed there was no problem with the selling of tax reductions because the Treasury could always step in and challenge egregious cases. *Danielson*, 378 F.2d at 778. The court made it clear that there were two principal reasons for these rules, reasonable predictability and administrative convenience. It wanted the parties to be able to rely on the tax agreement. *Id.* at 775. Furthermore, it wanted the Treasury to be able to accept contracts at face value without having to go back to relitigate the substantive provisions.

Judge Stanley's dissent cogently presents opposing arguments which have proved persuasive in limiting the "fraud" rule to the Third Circuit. His position is applicable also to "strong proof" requirements as well. *See* Judge Rives' dissent in *Balthorpe*, 356 F.2d at 34 where he finds the allocation too much of a sham. Stanley stated: "Taxes depend on what is done, and to allow the parties to shift the tax burden, even willingly, is beyond the power of Treasury . . ." Judge Stanley's position might be undermined in a way not contemplated by the court. No one has the power to force the Treasury to collect taxes. It has an almost unlimited power of compromise on particular issues, either on individual cases or in general. Therefore, if it chooses to allow the parties to contractually sell tax reductions, it can accept the lower taxes involved, it might read the contract as a contract to pay another's taxes, which is in essence what the sale of tax reductions represents. By agreement to a wholly fictitious covenant not to compete, the seller might be characterized as agreeing to pay a portion of the buyer's taxes under a formula set by the Internal Revenue Code. So far, so good. The problem is in not requiring the agreement to contain this express requirement: that the seller knowingly understand that he is agreeing to the payment of extra taxes. *See, e.g.*, Levinson v. Comm'r, 45 T.C. 380 (1966) (seller loses) where the buyer was careful to emphasize the tax reasons for the covenant, and the seller admitted he understood the consequences of the allocation.

Presumably, everyone would be satisfied if there was an administrative requirement by the Treasury that the seller must have understood that he was assuming part of the buyer's taxes while the Treasury authorized this assumption and administratively deleted from the buyer's gross income the payment of taxes (Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929) (payment of employer of employee's federal income taxes constitutes additional income to the employee in the year of payment). The Treasury and the parties would have their predictability, and the Treasury would be able to purchase administrative convenience at the price of some limitation of revenue. Of course, as assignee of the contract, the Treasury would not have the array of enforcement powers against the tax reduction buyer that it has against the primary taxpayer.

[42]For years courts used the "severability" test to determine whether amounts allocated to the covenant were allowable, generally by the buyer. The test had some virtues since the buyer only received the benefits of amortization of the covenant if there was proper proof of the amount allocated to the covenant. But, the test was misfocused. Sellers began to argue that even carefully bargained for covenants were not "severable" from the underlying goodwill they were designed to protect. The test fell into disfavor in the 1960s. *See Balthorpe*, 356 F.2d at 31 (seller loses).

does not reflect the correct understanding between the parties.[43]

The functional difference between this "strong proof" and the Treasury's "fraud" standard lies is how the taxpayer can meet his "strong proof" burden. An extremely high burden results in the Treasury's "fraud" standard by a different name, while a very low standard leads back to the problems with the "substance" method of classification. How the taxpayer meets his "strong proof" standard is confusingly unclear even within the Tax Court.[44]

As to property settlement cases, these cases amply illustrate the confusion caused by an inconsistent method of tax interpretation. Prior to 1985, the divorcing parties could structure the transaction so that some or all of the post-divorce cash payments from husband to wife were classified as alimony rather than as payments pursuant to a settlement of the parties' property rights.[45] This allowed wealthy husbands to deduct the payments from their income, saving up to 50 cents in tax for each dollar deducted. The wife included that dollar in her taxable income, paying perhaps 20 cents in tax. There was a 30 cents per dollar savings by classifying the payment as alimony which they could split between themselves by increasing the husband's net periodic payments to the wife. In effect, the wife was selling her tax lower bracket to her husband.

Early in the 1970s, the Treasury unsuccessfully attempted to import the fraud rule into the divorce property settlement area. Often the husband attempted to call payments both "property settlement" payments for state law purpose, making them unmodifiable, and "alimony," making them deductible.[46] Not infrequently, in the second or later years, as the tax conse-

[43]Clesceri v. United States, 45 A.F.T.R.2d 80-634 (1980) (discussion of varying standards among circuits); Coven v. Comm'r, 66 T.C. 295 (1976) (seller able to show "strong proof" that express allocation in superceding "tax" contract was unrealistic). The Tax Court opinion in *Danielson,* reversed by the Third Circuit, found on similar facts that the sellers had met their "strong proof" burden. *Danielson,* 44 T.C. 549.

The "strong proof" test is as defective as the other tests developed in this area, being marginally better than the unworkable "severability" test. The major problem is that courts can not impose a uniform standard of proof on themselves, thus, leading to identical cases being decided differently.

[44]Recent cases focus alternately on objective and subjective sub-tests. The objective test is whether a reasonable businessman looking to his future would bargain for the covenant. The subjective test is whether the parties to the negotiation really bargained over the covenant. Under the objective test, the seller might show that he was unable or unwilling to compete. Under the subjective test, the seller might show that there were no negotiations and that the buyer slipped the covenant into the contract without negotiation.

Sometimes the Tax Court emphasizes one verbal formula, sometimes the other. Compare the results and verbal formula of O'Callaghan v. Comm'r, T.C.M. (PH) ¶ 84,214 (1984) (verbal formula: whether there is "some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement . . . . *id.* at 84, 219) with Goldstein v. Comm'r, T.C.M. (P-H) ¶ 84,061 (1984), (verbal formula: the "key inquiry is whether the parties intended to allocate a purchase price to the covenant").

These two cases are consistent in results even though the emphasis of the verbal formula differ. *See also* Schulz v. Comm'r, 294 F.2d 52 (9th Cir. 1961). The subjective test is really more than one test. Sometimes the parties' intent is taken as evidence of the importance of the covenant. At other times, it refers to their intent to allocate the tax burden between themselves.

[45]*See supra* notes 28-31 and accompanying text.

[46]Wright v. Comm'r, 543 F.2d at 599 (wife loses) ("It is not uncommon for the parties to provide for such payments, in lieu of alimony, where they wish to insure that the decree of divorce will not be subject to later modification by the Court.") Roberts v. Comm'r, 43 T.C.M. (P-H) ¶ 74,175 (1974) (wife's attorney insists

quences of her bargain begin to materialize for the wife, she, like the business seller, challenged the classification of the "alimony" payments, arguing that despite the allocation set out in the divorce agreement, the payments were, in substance, not for her support. The Treasury's proffered "fraud" standard was decisively rejected in two successive cases.[47] Moreover, the parties were not held to any unusual standard of proof, such as "strong proof," to overcome the agreement's classification. The wife was often successful in reclassifying the payments.[48]

As to child support cases, a similar sale was possible when there were minor children involved in the divorce. Child support is not deductible by the husband. Allocation of some of these payments to alimony again allowed the wife to sell some of her lower brackets in exchange for higher net payments. Confusion similar to that found in the property settlement area reigned until placed to rest by the United States Supreme Court in 1961.[49] There the Court had the wisdom to see that the traditional judical approach of trying to find a transactional "substance" with which to classify the transaction did not work in areas where the same transaction could with equal validity be classified in more than one category with differing tax results to the parties. In effect, the Court resolved this dilemma by allowing the parties to choose the category between them, reducing future controversies in that area.[50] The number of child support cases dropped after 1961 when the Court adopted a parties' choice method. By contrast, the number of property settlement cases without such a method continued unabated.[51]

Sale-leasebacks are properly part of the second pair of transactions and will be discussed in more detail in the next part, but it is appropriate to note here that in the sale-leaseback area, the Supreme Court came to a similar con-

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that the payments be a "property settlement" since Washington state courts are thereby precluded from later modification).

[47]Gerlach v. Comm'r, 55 T.C. 156, 168 (1970); Mirsky v. Comm'r, 56 T.C. 664, 674 (1971) (wife successfully reneges). *See also O'Callaghan*, T.C.M. (P-H) ¶ 84,214 at 819 and Malgoire v. Comm'r, T.C.M. (P-H) ¶ 78,029, at 182 (1978) (where the Treasury was still unsuccessfully pushing the 1967 "fraud" position).

[48]If as a factual matter, the payments appear to be genuinely for "alimony" or for "property settlement," then despite the parties' apparent agreement as to the tax consequences, they were quite successful in reneging and reclassifying the payments to their advantage (and the other parties' disadvantage). See Land v. Comm'r, 61 T.C. 675, 677 (1974) where the agreement was explicit at two points expressing the following agreement: "[it is the parties'] intention that this provision qualify under Sections 71, 72 or 215 of the Internal Revenue Code, for taxable income and deductible expenses of the parties hereto." Looking to the substance of the transaction, the court found the payment was a property settlement despite this agreement. This was not a consolidated case.

[49]Comm'r v. Lester, 366 U.S. 299, 304 (1961) (alimony deduction allowed father in unclear written divorce agreement). The Court noted:

> As we read [I.R.C. section 71(b)], the Congress was in effect giving the husband and wife the power to shift a portion of the tax burden from the wife to the husband by use of a simple provision in the settlement agreement which fixed the specific portion of the periodic payment made to the wife as payable for the support of the children.

Id. at 304.

[50]*Lester*, 366 U.S. at 299.

[51]*Compare* COMMERCE CLEARING HOUSE, *supra* note 44, at 6 with the limited number of cases after *Lester* in 1985 FED. TAXES (P-H) p. 7714.

clusion, allowing "parties' choice" in a sophisticated financing transaction, a principal purpose of which was to shift the tax benefits to one of the parties.[52]

The "parties' choice" method does therefore resolve tax classification disputes, but is not without problems of its own. Chief among these is the difficulty courts have with a shifting standard, where the "substance" criteria is used to narrow and "parties' choice" to complete the classification. The cases clearly indicate that the courts become confused and are not very adept at applying a shifting standard. This is indicated by the refusal to use any different standard for property settlement cases and the refusal of courts generally to adopt the Treasury's "fraud" standard.

Among other things, it is not clear when the shift from the "substance" standard to the "parties' choice" standard occurs. In the pre-1985 divorce child support cases, there was at least a bright line threshold criteria: allocation was allowed only if the parties had a minor child. But how much property is enough in the pre-1985 property settlement cases? And in the business sales area, what happens when a 93 year-old man wants to "sell" a covenant not to compete, even though he is clearly too enfeebled to compete effectively.[53]

This is essentially a problem of assuring uniform tax results for similar fact patterns. Confusion results unless all of the decision makers (the parties, the Treasury, and the courts) agree (1) on when the shift occurs, (2) on the conditions under which "parties' choice" will be observed, and (3) on who is bound by the "parties' choice" standard.

The pre-1985 child support area provides the best example of a "parties' choice" standard which worked reasonably well. The condition of the shift was that the parties had a minor child. The 1961 Supreme Court case effectively granted them absolute power to allocate payments between "alimony" and "child support," enforceable between themselves and against the Treasury. The parties, the Treasury and the courts, were all bound by the parties' decision. This effectively gave them the power to transfer taxable income to the wife's more lightly taxed brackets.

The shift in business sales and in sale-leasebacks, among others, does not work as well. There is no clear line for when the shift in standard occurs. Ironically, a conscientious court which works hard to find the transaction's "substance" may reach a different result than a court which summarily disposes of the case with "parties' choice." This is a bad result for those who

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[52]*Frank Lyon Co.*, 435 U.S. at 561.

[53]The Rule against Perpetuities brought certainty to property law by conclusively presuming an 80 year old woman could bear children. The Treasury's "fraud" standard, particularly as proposed in the Tax Court, would effectively reach the same result by allowing the Treasury (and the parties) to lift the tax consequences from the face of the document, just as the Rule against Perpetuities allows courts to determine *ab initio* the validity of future interests from the granting instrument and the parts at the time the grant becomes irrevocable.

believe similar cases should have similar tax results.

Another problem with the "parties' choice" method is the problem of the overreaching or cheating party, who tricks agreement to the tax deal without his opponent understanding the agreement. A related problem is the attempt by one of the parties to renege on the tax deal after it is fixed.[54] The former is a common problem with the first pair, business sales[55] and divorcing wives.[56] It is almost never a problem with the second pair, presumably because everyone knows what the tax consequences are. Furthermore, at least in the partnership special allocation area the annual distribution print-outs are reported consistently on the partner's returns. One could argue this is essentially a non-tax problem, proceed to draw the tax consequences from the "parties' choice" paper transaction, and thus place the burden on the taxpayer's counselor to know the tax consequences of the deal.[57] If the objective is to reduce cases, though, it might be better to refuse the sale of deductions unless there is an express contractual clause fixing the *tax* deal between the parties.

The whipsaw of the Treasury by the parties is an even more insidious problem: both parties win everything at the expense of the Treasury.[58] It is not uncommon for lawyers purposefully to leave the classification blank, allowing the parties to fill in their own classification at tax time.[59] Divorced husbands

[54]In Smith v. Comm'r, 331 F.2d 298 (7th Cir. 1964) one of two partner-brothers agreed to take all partnership income as his income and pay the other's taxes, but filed a partnership return reneging on his agreement. The court held the taxpayer to his bargain.

[55]Payne v. Comm'r, 22 T.C. 526, 531 (1954) (where the court emphasized the buyer's duplicity).

While it is more common for the buyer to be duplictous, the seller may also take unfair advantage by knowingly accepting extra compensation for agreeing to a particular tax result, then trying to get out of his bargain after he has been paid. *See* Levinson v. Comm'r, 45 T.C. 380 (1966) (The seller knew and agreed to the tax consequences of allocation of most of the purchase price to the covenant).

[56]The cases indicate that divorce attorneys (but not their female clients) understand the tax consequences. Business lawyers frequently do not understand. Amusingly, attorneys are frequently found as business sellers. *See* Hamlin's Trust v. Comm'r, 209 F.2d at 762 (sellers unaware of tax consequences but are held to their deal). Yale Law School graduates are apparently more perceptive, or luckier. Ballantine v. Comm'r, 46 T.C. 272 (1966).

[57]J. Raum in *O'Callaghan*, T.C.M. (P-H) ¶ 84,214 (seller was misled by the buyer but loses to the Treasury anyway) *citing* Upton v. Tribilcock, 91 U.S. 45, 50 (1875) (stockholder required to pay for stock despite bad advice by sellers).

[58]IV INTERNAL REVENUE MANUAL 424(10). ("goodwill v. covenant not to compete; . . . alimony v. child support . . . . Every reasonable effort should be made to secure the return of the taxpayer on the other side of the transaction to insure that he/she is not treating the transaction inconsistently . . .") Increasingly, the Treasury has been throwing buyers and sellers into court together and remaining neutral on the allocation. *See Levinson*, 45 T.C. 380 (contractual allocation upheld). It has been said that "[t]he strong proof" standard does not apply in such business sales cases. Peterson Machine Tool, Inc. v. Comm'r, 79 T.C. 72, 82 (1982) (roughly one-third allocation allowed). Sellers have a much better chance of arguing that the contractual allocation is unrealistic. *See Malgoire*, 47 T.C.M. (P-H) ¶ 78,029 at 180 (seller loses).

If reported inconsistently, the Treasury usually takes an inconsistent position as to both, consolidates the two cases, and acts mainly as a stakeholder. *See, e.g., Beard*, 77 T.C. at 1275.

[59]*See Ballantine*, 46 T.C. at 272 (The parties on both sides of the negotiating table knew of the tax consequences of the goodwill allocation and declined to make a specified allocation); and Miller v. Comm'r, 33 T.C.M. (P-H) ¶ 64,305 (1964) (The parties understood the tax consequences of the allocation and, unable to agree, allocated a gross amount of $11,500 from the total $37,500 purchase price to "goodwill of said business and for the covenant not to compete."

claim twice the amount of "alimony" deductions as divorced wives report in income. One commentator, in discussing the leading sale-leaseback case, derisively noted that both parties took the deduction for the property.[60]

This is essentially a control problem. Congress has taken the first step in the post-1984 divorce area by requiring information with which to allow matching the parties. Assuring consistent reporting is a way of easing, if not resolving, the problem.

To summarize, in some areas, the "substance" standard leads to confusion and an inability to resolve cases. "Parties' choice" allows for the resolution of cases, but primarily because of a shifting standard leads to confusion.

3. A Suggested Alternative: Adopt a General Interpretative Position Against Sales of Tax Reductions

The problems with "parties' choice" are sufficiently serious that consideration should be given to an alternative approach. Failing a Congressional solution (or similar solution through delegation to the Treasury),[61] one option open to a court faced with a tax classification problem is a traditional one: place the burden on the taxpayer and deny tax reductions to everyone. If a taxpayer wishes either to fit his transaction into a favorable category or resist the Treasury's fitting him into an unfavorable one, he would have the burden. Rigorously applied in each of the transactions examined here, though, the approach would result in the Treasury winning most cases, on *both* sides. In business sales, the allocation may be to the covenant not to compete as to the business seller but not to such covenant as to the buyer. In pre-1985 divorces, former wives might have "alimony" income which is not classified as such as to their former husbands. Finally, no one might "own" and thereby be able to depreciate sale-leaseback property.

This approach has not been taken generally, except for the case where one of the parties has already classified the transaction consistently and as to him

[60] Wolfman, *infra* note 80, at 1075. (criticizing the Supreme Court opinion in *Lyon* as well as the government's bungling of its advocacy before the Court).

[61] Many of the problems of "parties' choice" could be ameleorated by expressly giving the Treasury greater legislative power to adopt "parties' choice" in difficult cases. *See supra* note 48 and accompanying text.

Presumably the Treasury has more technical expertise. Congress provides a purer reflection of political preferences. The courts are presumably the worst alternative since (1) many have no special expertise (except the Tax Court); (2) bright line rules can not be provided; and (3) the courts have limited political accountability.

Two weak arguments can be made against this suggestion. First, it might be argued that taxpayers should be able to rely on the Code as written without worrying about the possiblity of some interpretation, or lack of enforcement, known only to specialists. Taxpayers or their advisors should have some assurance that there is not a shifting standard of interpretation applied in different sections of the Code, making interpretation more uncertain and expensive. This is a weak argument because while one cannot reasonably expect a taxpayer, or his advisor, to read every case before filling out his tax return or structuring his transaction, one can expect him to read the Treasury's regulations. Second, one might argue that Congress, not the Treasury, should determine the tax consequences of fact patterns presented for tax classification. This is a weak argument because such delegation is well within the boundaries of permissible Constitutional delegation.

the classification stands because of the statute of limitations.[62] It violates the notion of fairness, essential to the system. The same definition should apply to the same facts regardless of whether the Treasury can benefit from inconsistent definitions.[63]

Another easily dismissed classification possibility is to allow both parties to classify the fact pattern most favorably and both claim the tax benefits. Administratively, this obviously happens. As mentioned, the pre-1985 system of matching up divorced husbands and wives produced twice as much "alimony" deducted by ex-husbands as was reported by ex-wives; and in the leading sale-leaseback case, both parties took the depreciation deduction.[64]

The new post-1984 divorce Section 71 suggests a promising solution for resolving cases, and avoiding "parties' choice" while securing predictability. It is to adopt a principle that the least favorable general position to taxpayers in the aggregate should be taken unless the reduction buying taxpayer is able to show that the deal should be classified in another way.

In business sales, the presumption would be that all of the extra value would be allocated to goodwill (the general least favorable tax position). In almost all transactions, the business seller will be happy to report this way, because he receives capital gain treatment for the sale. The usual tax controversy would be between the business buyer and the Treasury. Courts could require the buyer to show all of the following to overcome the presumption: (1) that there was a covenant not to compete; (2) that there was a realistic chance that the seller could have competed; (3) that an amount was specifically allocated to the covenant; (4) that this amount was reasonable under the circumstances;[65] (5) that the contract of sale described the tax consequences of the covenant to the seller;[66] and (6) that the seller agreed to report the covenant's income as taxable income rather than capital gain. The buyer should also have to report the seller's income tax identifying number.

In the divorce area, the presumption, as it is in the post-1984 new divorce provisions, would be against taxable income being shifted to the former wife. The usual tax controversy would be between the former husband and the

[62] *But see Peterson Machine Tool, Inc.* 79 T.C. at 81 ("each party bears burden of proving . . .").

[63] *Patterson,* [P-H] T.C.M. ¶ 85,053, (burden announced to court allows taxpayer to show no allocations).

[64] *Wolfman, infra* note 80.

[65] One might ask: (1) did the covenant have enough substance so that reasonable men might bargain for it?, and (2) was an appropriate amount allocated to the covenant? *See Levinson,* 45 T.C. at 380 (where the court is quite sure (1) is met but not (2)).

[66] Annabelle Candy Co. v. Comm'r, 314 F.2d 1, 7 (9th Cir. 1962) ("rocky road" candy corporation buyout; buyer not allowed to challenge allocation) (where the court would hold the parties to their bargain since otherwise the "tax consequences which they contemplated as incident to the benefits and burdens of the contract would be disturbed").

Treasury.[67]

This judicial solution has the virtue of avoiding two methods of classification being applied to the same fact pattern. It yields a single classification for both parties and avoids most of the other problems associated with either a naked "substance" or an alternate "parties' choice" approach. In addition, it is consistent with the approach which will be recommended in the second pair of "tax shelter" cases discussed next.

The anti-sales solution is not perfect. One objection is that courts would find it difficult to determine the pattern of tax sales with which to apply the presumption. Yet, in the four transactions examined here, the pattern of tax sales is almost patently obvious. Determining this pattern should be no more difficult than determining the transaction's substance.

A more serious objection is that in cases where the tax positions of the parties are reversed, interpreting against sales *in the aggregate* will allow "parties' choice" and sales of tax deductions *in the particular* case which runs against the grain. For example, the rich woman receiving custody of her children would be able to elect to characterize payments as "child support" (as she is allowed under present post-1984 law), thereby purchasing her husband's lower tax bracket. A court faced with this problem would have to either interpret against sales in the particular (and thereby against the woman) or in the aggregate. The post-1984 divorce sections line up on the side of an aggregate, rather than a particular, classification.[68]

In sum, because of problems with the "parties' choice" method of resolving questionable tax disputes, an alternate should be tried; that is, courts should interpret against the sale of tax reductions. There is only limited authority supporting this approach.[69] It may, like the "severability"[70] and "fraud"[71] tests, prove to be a failure. However, it looks like a promising solution and should be tried.

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[67]"No sale" is the most beneficial to the Treasury, so it is no trick to make sure that the payment fails to qualify under new I.R.C. §§ 71(b)(1)(B) and 215 (1984), *rev'g Lester,* 366 U.S. 299.

[68]"No sale" is easy to achieve. The parties can disqualify a tax reduction sale by fixing an amount as child support. In addition, the new section independently finds a "no sale" when certain payments which are reduced upon a child "attaining a specified age, marrying, dying, [or] leaving school . . ." I.R.C. § 71(c)(2)(A). While the committee reports reflect no hint of concern about sales of tax benefits pursuant to a "parties' choice" standard, the net effect is to practically eliminate sales and strengthen the literal interpretation of the Internal Revenue Code.

In the property settlement area, the new provisions also make a "no sale" easy to achieve. All the parties have to do is designate the payment in the agreement as not being "alimony." There is an economic risk to the wife. In order to be alimony, her benefits have to end at death. It is less clear whether the parties have an equal power to effectuate a "sale." *Id.*

[69]*Cf. Peterson Machine Tool, Inc.,* 79 T.C. 72 (Tax Court's substantive allocation to the covenant upheld).

[70]*See Balthrope,* 356 F.2d at 31.

[71]*See supra* note 41.

II. THE TAX SHELTER MARKET PROBLEM: HARM TO THE APPARENT FAIRNESS OF THE TAX SYSTEM

A. *Progressivity and the Perceived Federal Income Tax System*

This part of the article centers on the second pair of the four transactions examined, sale-leasebacks and partnership special allocations.[72] Close analysis of the limited number of cases in this second pair reveals a central problem which is quite different from the first pair.

Like the first pair, ambiguity seems to require "parties' choice" for decisive classification which in turn opens the door for sales of tax reductions. The major difference is that these transactions, unlike the first pair, are not self-limiting. Anyone can participate. Tax shelter promoters are a major force here.[73] Furthermore, the judicial response is different.

Naturally, one would assume that the difference arises because of the greater possible effect on the tax system's progressive rate structure. Judging from the cases, admittedly a limited research base from which to build an explanatory model, this is not the central concern. The leading cases do not discuss the relative tax brackets of the parties.[74] Once it is clear that one of the parties is entitled to the deduction, courts, at least, seem unconcerned with *which* party can take it. Judging from many of these cases and from other evidence as well, one might conclude that progressivity in the upper tax brackets is not a very important feature of the *actual* federal income tax system, as opposed to the *perceived* system.[75]

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[72]These two transactional forms sometimes appear together in cases. *See* Hilton v. Comm'r, 74 T.C. 305 (1980). (with a combined limited partnership and sale-leaseback).

[73]The control the promoters have over the shelter vehicle eliminates the problems which were central in the first pair. In this second pair, generally everyone reports consistently, and there is no "fraud" problem here.

[74]*See Estate of Starr,* 274 F.2d 294 ("lease" of sprinkler system held a "sale.") The theoretical debate concerning progressivity as a structural feature of the federal income tax has been extensively explored elsewhere and is beyond the scope of this article. *See* W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953) (the classic critique of progressive taxation) and R. PAUL, THE STORY OF PROGRESSIVE TAXATION, TAXATION IN THE UNITED STATES 714 (1954).

There is other data. *See* J. PECHMAN, FEDERAL TAX POLICY 127, Table 4-13 (1983) which shows that effective tax rates rise only to about 23% of "expanded adjusted gross income" of $1 million or more. *See also* E. BROWNING & W. JOHNSON, THE DISTRIBUTION OF THE TAX BURDEN 63 (1979) (federal taxes of all types reach 23.9 percent in the top tenth of income class, as defined in the study). 4:1 STAT. OF INCOME BULL. 123 Table 3(14) (Summer 1984) The tax as a percentile of 1982 adjusted gross income (AGI) ranges from 27% of $100,000 AGI to 40% at $1 million AGI.

[75]One must be clear about what one is calling the "actual" federal income tax system. While it is perfectly sensible to talk about the collective illusion of a progressive system as part of the actual system, for clarity that convention will not be adopted here. The "actual" system referred to is the tax system as it actually works absent its "perceived" system. The perceived system is the collective image of the federal income tax system.

Progressive rates on large incomes raise relatively little tax because such incomes encompass such a small percentage of total income. Taxable income of those with $100,000 or more of adjusted gross income in 1980 was $84 billion or about one-half of one percent of the 1.3 trillion in 1980 adjusted gross income. 3:4 STAT. OF INCOME 92 Table 4(5) (Spring 1984). *See also Soak the Rich? It Wouldn't Balance the Budget,* U.S. NEWS & WORLD REP. 59 (Sept. 17, 1984) ("[I]f all persons with income of $100,000 or more paid a 100 percent tax, [it would raise only] 68 billion in added revenue [for 1984].") The total estimated net worth of the

The cases' approach indicates that progressivity has more of an administrative function. The main purpose of progressivity may be a contribution to the general perception of the tax system's fairness, which is an essential administrative feature of an efficient, self-assessing income tax system.[76] If this is true, then this perception can be advanced by an apparently progressive system. It is not necessarily advanced by an actually progressive system. The best system could even be one that was only apparently, but not actually, progressive.

One way of testing this proposition is to uncover cases where progressivity is only apparently, but not actually, threatened. Here the cases in the sale-leaseback and the partnership special allocation areas are especially revealing. In many of these cases, the tax reductions being sold are benefits that any individual acting alone could have by a single investment. The harm apparently is the fragmentation and marketing of these tax benefits to unrelated investors. The Treasury's present auditing focus on tax shelters seems to corroborate this analysis. A promoter almost by definition, has to tout his wares. The touting itself, since it tarnishes the perception of fairness, may be the principal harm. When, as in the business sales and divorce transactions, there seems little likelihood that a national tax shelter market can develop, the cases do not seem hostile to the sales of tax reductions.

The central role of taxpayers' perceptions in the tax system requires different conditions for satisfactory solutions in this second pair of transactions, and by probable extension, to other forms of anyone-can-play sales of tax reductions as well.

B. *Marketed Sales of Tax Reductions: Sale-Leasebacks & Partnership Special Allocations*

1. Sale-Leasebacks

The essential elements of a sale-leaseback transaction are a sale, a

four hundred richest Americans is $134 billion. A 100 percent income tax would yield only about $15 billion annual revenue. By comparison the estimated 1985 U.S. budget deficit is $211 billion. FORBES, October 28, 1985, at 206.

Nor is it clear that such rates would actually perform other functions generally ascribed to them, such as estate-leveling.

[76]Such cases as *Danielson* (the "fraud" rule), *Lester* ("parties' choice" in child support discussed at *supra* note 33), *Frank Lyon Co.* ("parties' choice" in sale-leasebacks discussed *infra* note 80), and the partnership special allocation provisions of I.R.C. § 704(b) (1984) can all be read as limitations on the actual progressivity of the federal income tax system. This reading is wrong because if one is willing to allow actual progressivity to be limited, one should be willing to do so through direct, rather than indirect, modification of the federal income tax structure. The indirect method requires transactions costs (lawyers, accountants, and promoters) of about 15%. *See* safe harbor leasing discussed at *supra* note 5. Administrative convenience for the tribunal wishing to manage a case load economically and expeditiously is a much better explanation.

On the other hand, concern for the illusory tax system is probably the best reading of why such leading cases as Orrisch v. Comm'r, 55 T.C. 395 (1970) (partnership special allocation disallowed), Allison v. United States, 701 F.2d 933 (Fed. Cir. 1983) (partnership special intangible drilling cost allocation disallowed) and *Hilton*, 74 T.C. 305 (taxpayer again loses in sale-leaseback case) refuse to follow the cases allowing "parties' choice." Naked, open and notorious sales of tax reductions have a detrimental effect on the perceived tax system. *See infra* note 75.

lease(back) and frequently an option to repurchase.[77] For convenience, the cases analyzed in this article will be drawn from a small group closely akin to, but more or less distinguishable from, other similar transactions.[78]

An oversimplified example of a sale-leaseback illustrates the transaction. Railroads (RR) need boxcars to operate. Boxcars are depreciable, but many railroads until recently had no taxable income against which to write off the depreciation deductions. Valuable tax deductions were simply lost each year. However, if a railroad "sold" a boxcar to a high bracket investor such as a successful doctor (Doc) and then leased it back, the doctor would have depreciation deductions to offset his income, the railroad would have the boxcar to use, and the lease payments would be adjusted to reflect a portion of the tax deductions now employed to reduce the Doc's taxes.[79] Like business sales and divorce agreements, the Treasury absorbs the total loss in tax revenue resulting from the reallocation of tax benefits.[80]

The sale-leaseback cases are a sort of do-it-yourself version of the congressionally sanctioned safe-harbor leasing allowed primarily in 1981 and 1982.[81] The critical difference is that these transactions cannot be merely paper transactions. Furthermore, sale-leasebacks, unlike the business sales and divorce

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[77]See e.g. the steps in a sale-leaseback decision summarized at 435 of Shurtz, *A Decision Model for Lease Parties in Sale-Leasebacks of Real Estate,* 23 WM & MARY L. REV. 385 (1982).

[78]Transactions falling under the rubric "sale-leaseback" cover a wide diversity of arrangements and purposes, both economic and tax. For convenience, this discussion will be limited to sale-leasebacks, even though a straight lease can have many of the same economic and tax functions. It will ignore gift-leasebacks in which the seller-lessor is attempting to transfer wealth gratuitously. *See* McMillion v. United States, 24 A.F.T.R.2d 5699 (1969) (taxpayer wins), The discussion will also ignore sale-leasebacks in which the seller-lessor is attempting to control the tax realization of an economic loss he sustained. Jordan March Co. v. Comm'r, 269 F.2d 453 (2d Cir. 1959) (taxpayer wins.).

[79]Simonson, *Determining Tax Ownership of Leased Property,* 38 TAX. L. 1, 31 (1984). *See also* Faber, *Determining the Owner of an Asset for Tax Purposes,* 61 TAXES 795-809 (1983). Rev. Proc. 85-12, I.R.B. 1985-12, p. 3 section 4(9) allows no advance rulings on this issue.

[80]Discussion of non-safe harbor sale-leasebacks must begin with the 1978 Supreme Court cases of *Frank Lyon Co. v. United States,* 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976) which is analogous to *Lester* in the child support area. *Lyons* involved an Arkansas bank which found it could not finance a new building for itself and had to turn to a sale-leaseback transaction. This transaction was structured so as to provide only the most minimal risks to the nominal "owner" of the property, who borrowed all but $500,000 of the purchase price. The transaction probably could have been structured as a typical sale-leaseback, giving the bank the depreciation deductions. However, the transaction was structured to transfer those benefits pursuant to the transaction to Frank Lyon Co., whose majority stockholder and board chairman also was a member of the Arkansas bank's board. The Eastern District of Arkansas found the transaction was not a sham and allowed Lyon Co. its deduction. 36 A.F.T.R.2d 75-5154 (E.D. Ark. 1975.)

The Eighth Circuit reversed. The court reasoned that the transaction, viewed substantively, looked more like a pure financing transaction in which the bank rather than Lyon was the owner of the building. The court recharacterized the transaction to follow its substance and, consistent with the approach of prior cases, held that the bank was the true owner of the building for tax purposes. 536 F.2d 746, 754 (8th Cir. 1976).

The Supreme Court reversed the Eighth Circuit and allowed the form of the transaction to control the tax consequences. The Court allowed Lyon, the buyer-lessor, the depreciation tax reductions purchased. (In his article, *The Supreme Court in the Lyon's Den: A Failure of the Judicial Process* 66 CORNELL L. REV. 1075 (1981), Professor Wolfman notes that since the bank also had taken the depreciation deduction, the deduction had been allowed twice through administrative oversight.)

[81]*See* Riles, *Safe Harbor Leasing, 1981 and 1982,* 3:4 STAT. OF INCOME BULL. (1983). Those interested in all the figures of an actual transaction should *see Hilton,* 74 T.C. 305 (partnership, taxpayer loses).

transactions, are much more open to comparison with other comparable transactions. A covenant not to compete or a spouse may have a unique value. However, a building lease or payments on a note can be easily compared with other comparable arms-length transactions.

The sale-leaseback transaction cannot be used to sell tax reductions as simply as the boxcar model depicted above. To illustrate, assume RR has enough real losses that, no matter how much income is allocated it, it pays no taxes. Correlatively, the tax shelter buyer (Doc) has enough income from his medical practice that no matter how much depreciation is allocated to him, he will still pay 50 cents in federal income tax on the last dollar of his taxable income. Ignoring ITC, assume further that the boxcar costs $10,000 , is five-year recovery property, the inflation/interest rate is about 10%, and that assets are worth about ten times earnings. This transaction is difficult for Doc to structure because he must actually pay $10,000 for the boxcar to get a basis to deduct. Over five years, as he depreciates his entire $10,000 basis, the taxes he pays will be reduced by only $5,000. In fact, since not all of the reductions will reduce current taxes, the present value of the stream of five-year deductions is only about $4,000.

The very most Doc should be willing to pay for $5,000 of tax benefits is the present value to him, about $4,000 cash. In order to get the rest of the $10,000 basis for the boxcar, Doc must give RR a $6,000 note. Rental payments will probably be keyed to Doc's principal and interest payments.[82] This is the "paper" part of the transaction that separates the cases analyzed in this section from the unreal, but congressionally sanctioned, safe-harbor leasing transactions which flourished in 1981 and 1982. Without the tax requirement for economic substance, there would be neither a $6,000 note nor rental payments. Yes, Doc is the "owner" of the property if everything goes well. However, the leaseback leaves RR in precisely the same economic position it was in when it "owned" the boxcar. The $4,000 represents payment for the tax deductions (not for the property).

Rental payments flowing toward Doc, therefore, approximate the principal and interest payments flowing back to RR. It is an economic wash, but after the first few years not a tax wash. All of the rental payments are income. Only the interest portion of the note payments is deductible. Increasingly then, taxable income will flow back in Doc's direction and RR will get rental deductions it does not need. Again unlike the business sale and divorce cases, the elements of these payments, lease, interest, etc., can be tested against an outside market to limit the flexibility of Doc and RR in structuring the payments to offset this effect of a reverse flow.

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[82]Sowerly v. Comm'r, 53 T.C.M. (P-H) ¶ 84,021 (1984) (rent exactly offset interest and principal).

2. Partnership Special Allocations

To a much greater degree than in the sale-leaseback cases, the term "partnership special allocations" denotes a method of transferring tax reductions used in a family of related but distinct transactions rather than denoting the transaction itself.[83] Two methods are illustrated in the following examples.

The first is an example modeled loosely on a leading case.[84] RR contributes $3,500 and Doc contributes $5,000 to the RR/Doc partnership. The respective partnership "capital accounts" (roughly, what they could take out if the partnership were liquidated) of each partner are $3,500 and $5,000. The partnership buys an $8,500 boxcar, which is leased to RR. Real lease payments are made by RR to the partnership representing the value to it of the boxcar of about $1,500. The written partnership agreement allocates all of the first year's $1,500 depreciation deduction to Doc, but requires him to reduce his capital account by the amount of depreciation allocated to him from $5,000 to $3,500. The partnership allocates all the current income to RR. RR is credited with $1,500 in income, increasing its capital account from $3,500 to $5,000. Assume (somewhat unrealistically) that the boxcar is sold for $8,500 and the partnership is liquidated. RR gets $5,000 of the proceeds. Doc gets $3,500.[85] Doc has bought his $1,500 deduction (worth $750 to him) at double its value to him.[86]

The second example of this family of partnership special allocation cases, substituting "Oil" for "RR," is also drawn from a leading case.[87] Oil contributes

[83]The tax consequences (if successful) are as follows. A partnership is not a taxable entity. I.R.C. § 701 (1984). It determines its income, gain, loss, deduction, credit, and other attributes at the end of each taxable year. I.R.C. § 703 (1984). In effect, it distributes them to the various partners for inclusion on the partner's tax returns. I.R.C. § 702 (1984). Since 1954, a partnership has been generally authorized to allocate specially those tax items to different partners by the partnership agreement unless the allocation does not have economic effect. Prior to 1976, the special allocation of partnership items was recognized under I.R.C. § 704(b)(1) (1975) for tax purposes unless "the principal purpose . . . [was] the avoidance or evasion of federal income tax . . ." The most important test given by the regulations in determining whether the principal purpose was tax avoidance was "whether the allocation has 'substantial economic effect;' that is, whether the allocation may actually affect the dollar amount of the partner's shares of the total partnership income or loss independently of tax consequences . . ." Treas. Reg. § 1.704-1(b)(2) (1975). In 1976, this test from the regulations replaced the code section it interepretes. Now, I.R.C. § 704(b)(2) (1976) disallows a special I.R.C. § 704(b)(1) (1976) allocation if under the agreement the allocation does not have "substantial economic effect."

[84]Orrisch v. Comm'r, 55 T.C. 395 (taxpayer loses).

[85]The tax consequences are as follows. A partnership is not a taxable entity. It determines its income, gain, loss, deductions and credits, and other attributes at the end of each taxable year and, in effect, distributes them to various partners for inclusion on the partner's tax return. A partnership is authorized to allocate specially these tax items to different partners by the partnership agreement unless it has been generally authorized to allocate these tax items to different partners by the partnership agreement, assuming the allocation does have substantial economic effect. I.R.C. § 704(b) (1984).

[86]Creating a deduction is easy. One only needs to walk through a tough neighborhood and get robbed, generating a theft deduction. Sometimes, investing $100 with a promoter, out of which the agreement pays him $20, leaving $80 to be actually put to work, is like the "theft" example. One has given up $20 in value to get (at 50% marginal rate) a deduction worth $10. *See* Rudnitsky, *The fellow who sold the Brooklyn Bridge to tourists might have done better packaging real estate syndications*, FORBES, Dec. 19, 1983 at 143.

[87]Hamilton v. United States, 687 F.2d 408 (Ct. Cl. 1982) (special allocation recognized since the deal was structured to follow transactions allowed in the regulations); *Cf. Allison*, 701 F.2d 933 (special allocation denied because there was not reduction in capital accounts).

nothing and Doc contributes $10,000 to the Oil/Doc partnership which will drill for oil. All of the losses and gains (known as "bottom line allocations") are specially allocated to Doc until the aggregate gains (when the well hits) allow payment back of Doc's $10,000 contribution. At this time, the allocations shift and Oil and Doc receive partnership income and liquidation proceeds in equal portions. The economic reality of this agreement is that if the well is dry, Doc has $10,000 of actual cash losses. Oil loses little since most of the risk is assumed by Doc. If the well hits, Doc gets his money back and half a producing well. Oil also gets half a producing well.

Assuming again that Doc has enough other income to place him in the fifty-percent bracket no matter how much loss is allocated to him, and Oil will have no taxable income even if the allocation is disallowed, the special allocation will mean that Doc's net cost after allocation of initial losses will be $5,000. If the well hits, he will recoup his $10,000 investment as income (which if ordinary will reimburse the Treasury for the $5,000 in taxes saved). After the shift, he and Oil will each have a half-interest in an oil well. The principal tax benefits to Doc are deferral and conversion into capital gain (if he sells his interest in the well). The principal tax benefits to Oil are presumably the conversion of his ordinary income labor into an interest in a well which can be sold at capital gain as well as deferred; that is, not recognized except as income from the well as received or when the well is sold.

The tax losses are obviously much more valuable to Doc than to Oil. However, the partnership special allocation is not necessary to achieve these results for Doc. Doc, and other innovators if necessary, could form a partnership and hire Oil, paying him either a salary or an equity share if the well hits, without making him a partner. This deal could have been structured as a straight investment by Doc along with Oil hired to drill and administer Doc's oil business, for which Oil would receive a salary. The partnership form and special allocation may be more for Oil's benefit than Doc's.

C. *Control of Tax Shelter's Harm to the Perceived Federal Income Tax System*

A surprisingly consistent composite picture of successful sales of tax reductions emerges from the separate transactions examined. The picture is out of focus, mainly because it is developed from an analysis of litigated transactions and only secondarily from legislative, administrative and other sources. Furthermore, the picture is incomplete because there are fewer reported cases for this second pair of transactions.

In these cases, the administrative convenience of the tribunal is an important, often decisive, force in the decision.[88] Filtering out this doctrinal noise

[88] Unlike the first pair, there appear to be hints of tax expenditure motives, injecting some doctrinal confusion. The real estate artificial losses marketed through both sale-leasebacks and partnership special allocations seem to fall into this category. At least one lower court case allowed a special allocation in an oil shelter

and disregarding the relatively insignificant pull of progressivity leaves the analyst with a residue from which to make generalizations.

Courts have not yet sorted out two quite different problems in this second pair of transactions. As with the first pair of transactions, courts are faced with a mismatch between the real world events (fact patterns) presented for tax classification and the definitional classifications into which to pigeonhole them. If the second pair of transactional cases is analyzed correctly, "parties' choice," in a game open to everyone, leads to promoters marketing tax shelters and thereby to the perception that the tax system is unfair. Since compliance and political acceptability is crucial to the tax system, any attack on the perception of the system's fairness must be met at one or more points. While courts have not yet recognized this interest doctrinally, they are faced with the additional problem in this second pair of transactions, that of protecting the integrity of the perceived tax system, the system as seen by taxpayers.

The perceived federal income tax system cannot be protected directly. In our political system, the dissemination of information to the public cannot be controlled directly,[89] nor would anyone suggest this as a solution.

There is no such constitutional limitation on an indirect attack. Among other things, one could limit the fragmentation of interests and thereby the potential for marketing these interests widely. For example, one could tax partnerships with more than 35 partners as corporations. Alternatively, one could reduce the profit margins from the sale of tax reductions by imposing onerous S.E.C. reporting requirements on the sale or by imposing costly audits on the transactional medium, sale-leaseback or partnership. However, once the goal is clear that one is attempting to limit the flow of accurate information about the real tax system, the propriety of this goal becomes questionable.

Arguably the appropriate response is to make the actual tax system fairer. One could avoid headlines such as "Over 3,000 millionaires paid virtually no federal income tax in 1983 . . ."[90] simply by requiring each taxpayer to pay some tax on real economic gain each year.

because of what appeared to be a congressional purpose to encourage oil exploration. (It is consistent with these tax preferences expenditures that they be purchased along with the underlying investments.)

One can explain sales of tax reductions largely on the basis of administrative convenience. However, in some anyone-can-play cases it is also possible to argue a tax expenditure purpose: to encourage people to invest in real estate or drill for oil. Congress attaches a tax carrot to the activity. Some have argued that allowing the naked sale of this carrot further enhances its value to the person engaged in the activity and is intended by Congress as an additional subsidy. Allison v. United States, 82-1 U.S.T.C. ¶ 9,163 (Ct. Cl. 1982) *rev'd* on this point, 701 F.2d 933. *Cf.* Note, *The Participation of Charities in Limited Partnerships*, 93 YALE L.J. 1355 (1984) (arguing that a charity should be able to sell its tax exempt status as a third subsidy in addition to exemption from corporate income tax and the ability to receive deductible donations).

[89] U.S. CONST. amend. I.

[90] DAILY TAX REPORT, August 2, 1985 ("[T]he new report is important because it shows the ability of taxpayers with substantial 'economic' income to avoid income tax by investing in loss-producing tax shelters") *see also* The Miami Herald August 2, 1985 at 1 (same story), *Some Rich Getting Free Tax Ride.*

Next, since it does not necessarily follow that making the system fairer automatically increases the taxpayer's *perception* of its fairness, accurate information concerning the fairness of the actual system should be disseminated.

Making the system fairer is primarily a legislative job. Arguably disseminating this information is an administrative one. However, what is the appropriate judical response to this second pair of transactions, similar to the first pair, where the classification is doubtful but "parties' choice" is a particularly dangerous standard of classification?

From the second set of cases, it is evident that courts generally resist sales of tax reductions, particularly in egregious cases where the tax reductions are being separated, like the sizzle from the steak, and marketed separately. The trend in the decisions is evident even though the opinions do not yet articulate the reason for the results.

Among other things, courts have resisted the separation and independent sale of the tax reductions by requiring an economic threshold.[91] In other words, they require the transaction, and even the allocation of tax reductions within the transaction, to have some reality other than as a naked sale of tax reductions. The reader will recall that in the first pair of transactions, this was not a fundamental problem. The tax reduction could not be separated from the rest of the transaction since it could only be marketed to the business buyer or to the husband. The overall transaction had economic substance. The business buyer was paying for the business assets as well as the seller's lower tax brackets. The husband was similarly paying dollars to the wife. For mainly administrative reasons, the cases in that first pair did not reflect a requirement that the *allocation* to the more favorable category (covenant or alimony) have some independent justification.

Courts are not yet clear on what counts as an economic threshold. It seems to require a gamble.[92] This gamble may be one of upward economic potential. One court required that the present value of the expected economic gain be greater than the present value of the tax reductions.[93] Other courts

[91]Rev. Rul. 83-47, 1983-1 C.B. 63 (no depreciation allowed lessors in townhouse sale-leaseback).

[92]Kresser v. Comm'r, 54 T.C. 1621 (end of year adjustment to partnership agreement disallowed; value of tax reductions calculable with precision); *see also Orrisch,* 55 T.C. 395 (sale of tax reduction disallowed where the value of the depreciation deduction was also determinable).

[93]*Hilton,* 74 T.C. 306 (naked sale through leaseback disallowed). *See also* Rev. Proc. 75-28, 54.07(1), 1975-1 C.B. 752 and I.R.S. Manual (audit) section 4236-872 (present value analysis for tax shelters). *Hilton* followed *Lyon* by two years. (The reader will recall that Lyon involved the Arkansas bank that was allowed by the United States Supreme Court to market its tax reductions on the ground it was impossible to determine the "true" owner in many sale-leaseback cases. *Hilton* involved a transaction which seems scarcely distinguishable from *Lyon* except that tax reductions were not sold to a single well established company but were rather clumsily fragmented through a tiered partnership and marketed to unrelated shelter investors).

A problem with the "present value" standard is how courts, without special training, determine present value of either the economic gain or the benefit of tax reduction. A more realistic standard is that the economic gain or loss be substantial in relation to the tax benefits. *See Lyon, supra* note 80. This is the sort of standard a court can be expected to determine.

have required the assumption of the risk of some economic loss.[94] For example, a leading partnership special allocation case required a "gain chargeback."[95] Taking the first of the two partnership examples given above, in order for the special allocation of partnership losses to Doc to pass muster, the partnership agreement would have to charge this allocation against Doc's capital account, both as a way of preserving a record of the allocation over into other tax years, and as a way of requiring that the special allocation itself have some potential economic consequences.[96] The parties can apparently share gains equally, if there are any to share, without taking into account the special allocation to Doc. However, if there are losses, these must be assumed by Doc in greater proportion because of the previous special allocation of tax reductions to him. The Treasury seems to require in sale-leasebacks that the risk be substantial[97] and that the risk consist of both potential for economic gain and for economic loss. Either alone is not sufficient.[98]

The cases seem to indicate that the increase in economic risk must come from the allocation, not simply from the transaction. In the leading Oil case, modeled above with Doc and Oil, Doc stands to lose his entire investment if the hole is dry.[99] Nevertheless, he must assume a greater risk of loss because of the special allocation. Otherwise, the special allocation will be disallowed (although he can share on a pro-rata basis in the general transactional losses when and if they occur.)[100]

Even after meeting the threshold requirement,[101] the fact pattern must still

[94]Even the Supreme Court in *Lyon* ("parties' choice" sale-leaseback allowed) discussed the risk to the buyer ("Lyon [the buyer/lessor], an ongoing enterprise, exposed its very business well-being to . . . real and substantial risk.") 435 U.S. at 577. The Court also indicated that Lyon assumed a tax gamble as well as an economic one. *Id.* at 580, n. 15. Frank Lyon Co. would have received tax benefits worth between $300,000 and $1.5 million for its $500,000 investment. See also *Smith*, 331 F.2d 298 where the sale of tax reduction was allowed, the court emphasizing the selling taxpayer did not know then if his taxes would be greater. In *Lyon*, Judge Stephens' dissent points out that the risk was in fact minimal. Frank Lyon Co. only assumed two risks: (1) that the lessee/bank might become insolvent; and (2) that the lessee/bank might not exercise its option in 25 years. However, it should be noted that while the likelihood of these two events occurring might be small, the consequences if they did were not. Frank Lyon Co. would have to shoulder the entire burden of the building until it could find a new tenant. (In fact, the bank has become insolvent, 1985).

[95]*Orrisch*, 55 T.C. 395. A chargeback reduces the liquidation payout to a partner on account of the special allocation. Treas. Reg. § 1.704-1(b)(2) (1984) takes the view that the potential for a lower payout is sufficient to meet this test. Prop. Treas. Reg. § 1.704-1(b) published March 9, 1983 contained an internal conflict, the basic rule was that the allocation must have some economic effect. Under Prop. Treas. Reg. § 1.704-1(b)(2)(ii), example 1 (vii), modeled closely on *Orrisch*, it appears clear that the special allocation would meet the threshold and have economic effect even though it would only reduce the payout if there were a loss. *See also* Ogden v. Comm'r, 84 T.C. 871 (1985) (no gain chargeback, no special allocation).

[96]This is also the capital analysis of *Orrisch* with the requirement of gain chargeback which assures that the present value of the tax benefits will be roughly half of their costs. *Orrisch*, 55 T.C. 395.

[97]Rev. Proc. 75-21 1975-1 C.B. 715. *See also* Rev. Proc. 75-28, 1975-1 C.B. 752 (procedure for obtaining a letter ruling under Rev. Proc. 75-21); and Rev. Proc. 76-30, 1976-2 C.B. 647.

[98]*See supra* note 99.

[99]*Allison*, 701 F.2d 933 (partnership special allocation disallowed because no gain chargeback.)

[100]Miller v. Comm'r, 53 T.C.M. (P-H) ¶ 84,336 (1984) (allocation lacked economic substance, but taxpayer allowed depreciation deduction on his ownership percentage).

[101]This raises a question. If the parties fail this test of a non-tax economic effect (or any of the other

be classified. In the sale-leaseback cases the available categories are crude: ownership by the lessor or ownership by the lessee, each with quite different tax consequences. As in the first set of transactions, in many cases the transaction's "substance" is simply not easily determinable for purposes of classifying a complex transaction. There is a trend away from "parties' choice" toward a visceral judicial antipathy to transactions which fragment and market tax reductions. While the evidence is not yet clear, at least in this second pair of decisions, courts do seem to be resisting marketed sales of tax reductions by construing the transaction against the sale.

Just as in the first pair of transactions, the courts' approach in sale-leasebacks and special allocations is rational. All four transactions spring from unclear classifications which spin confused bodies of precedents. "Parties' choice" as a method of classification creates special hazards in the second pair. However, all of the problems of the first pair are also present. Construing against the sale thus allows the same benefits found in the first pair. In addition, this approach marginally preserves the virtues of the perceived tax system by actually inhibiting tax reduction sales.

Applying this approach to the sale-leaseback cases, construing against tax reduction sales would require all of the extra value be allocated to the lease (the generally least favorable tax position). The usual tax controversy would then be between the lessor and the Treasury. Courts could require the lessor to show all of the following to overcome the presumption: (1) that there was a lease; (2) that the lease had some substance; (3) that an amount was specifically allocated to the lease payments; (4) that this amount, as compared with leases of comparable property, is reasonable; (5) that any note be similar to other arms-length arrangements; (6) that the note payments as compared to comparable payments of interest and principal be reasonable; (7) that the contract between the parties describe the tax consequences of the lease and note; and (8) that the lessor agree to report the income as taxable income. In addition, the lessor and lessee should both be required to report the other's income tax identifying number.

The use of this criteria against partnership special allocations is less clear because the medium is much more fluid and the internal transactions are much less open to comparison and control than sale-leasebacks. The facts of each case should make it clear, at least in promoted tax shelter cases, which way the tax reductions were being marketed and at which point the sales could be

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regulatory rules for successful sales), how is the fact pattern classified? This is not a significant problem in the partnership special allocation cases where a default classification is provided but is a potential problem in cases such as *Lyon*. The answer would appear in this case to be that the possible substantial economic effect for the allocation is so slight as to fail the threshold test. Then, the alternate classification will have a sufficiently strong economic effect to provide a clear alternative. In *Lyon*, the bank was the clear alternative owner of the building if Lyon failed the test. In addition, the test of interpreting against the sale of tax reductions handles this problem in most cases.

disallowed construing against tax reduction sales. Partnership special allocations would throw the burden on the limited partners or the partnership acting in their behalf. Two options are possible. The strong position would allocate all to the general partner unless the limited partners were able to make certain showings. The weak position would allocate reductions pro-rata based on the partnership's allocation of income and capital accounts, picking the least favorable of the two in case of ambiguity. The usual tax controversy would then be between the limited partners (or the partnership acting on their behalf) and the Treasury. Courts could require the limited partners to show all of the following to overcome the presumption: (1) that there was a partnership special allocation of depreciation or other reduction; (2) that the allocation had some economic substance, perhaps requiring capital account gain chargeback, and some risk as an economic threshold; (3) that the allocation was reasonable by comparing the rights and duties of the partner with those of nonpartnership allocations; (4) that the contract between the parties describe the tax consequences of the partnership special allocation; and (5) that the limited partner agree to reduce his or her capital account by the amount of the reduction. Finally, the parties should be required to report the partners' income tax identifying numbers.

CONCLUSION

As must be evident from recent events, the surface of tax law is in constant turmoil. I am more interested in features which lie below the surface. The cases from which the research base of this article is drawn are mainly pre-1985 cases and the article was written before the new IRC section 704(b) regulations were promulgated.[102] Nevertheless, its central discoveries remain perfectly valid. The fundamental way tribunals classify fact patterns, the "substance" method, does not always work, and expedient resort to the alternative "parties' choice" method creates its own unique problems. In most cases, the best solution is congressional legislation, tightening the categories along the lines of the post-1984 divorce provisions, or equalizing the tax treatment of indistinguishable fact patterns in order to reduce the flexibility of taxpayers in choosing favorable categories. For example, in business sales, Congress could make the tax results attributable to goodwill and covenants not to compete identical for the two parties.[103]

When a court must decide a case where the transaction's "substance" is not effective, it should resist resorting to "parties' choice." Especially in anyone-can-play transactions and marketed tax shelters, the principal harm is to the taxpayers' perceptions of the system's fairness. Courts should try to interpret against the flow of tax reduction sales.

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[102]Treas. Reg. § 1.704-1 (TD 8065, filed Dec. 24, 1985).

[103]This is the solution used to make the consequences of professional corporations' qualified plans the same as those of unincorporated Keogh plans.