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Survey Comment: Recent Developments in Tax Law in the Tenth Circuit

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Survey Comment: Recent Developments in Tax Law in the Tenth Circuit

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SURVEY COMMENT: RECENT DEVELOPMENTS IN TAX LAW IN THE TENTH CIRCUIT

INTRODUCTION

Tax Issues permeate a wide range of legal specialties from estate planning to changes in a business entity's corporate status. During the survey period of September 1, 2000 through August 31, 2001, the Tenth Circuit Court of Appeals published approximately 22 opinions dealing with some aspect of tax law.[1] The Tenth Circuit decided three cases of particular importance, which this comment analyzes.

The current state of tax law is still evolving. Each circuit court places its own spin on how to interpret the tax law contained in the Internal Revenue Code of 1986 ("Code"), as amended.[2] The first two Tenth Circuit decisions discussed in this comment establish "new" law, while the third decision simply reaffirms the past holdings of the Tenth Circuit.

The first case examined in Part I of this comment, addresses date-of-death valuation for determining individual estate tax liability. In *Estate of McMorris v. Commissioner*,[3] a case of first impression, the Tenth Circuit extended the date-of-death valuation rule announced by the United States Supreme Court in *Ithaca Trust Co. v. United States*.[4] The Court held that "events which occur *after* a decedent's death may *not* be considered in valuing" a § 2053(a)(3)[5] "claim against the estate" deduction.[6]

The second case discussed in Part II of this comment, addresses the deductibility of suspended passive activity losses ("PALs") carried forward to an S corporation. In *St. Charles Inv. Co. v. Commissioner*,[7] the Tenth Circuit held that when a taxpayer corporation changes its status from a C corporation to an S corporation, it is permissible to carry forward the suspended PALs, incurred during the years it was a C corporation, to the year it became an S corporation, and fully deduct those suspended PALs.[8]

The third case considered in Part III of this comment, addresses the test for determining the deductibility of salaries by a corporation as rea-

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1. Author's count based on Westlaw and Lexis searches.
2. *See* FRED W. PEEL, JR., UNDERSTANDING THE FEDERAL INCOME TAX: A LAWYER'S GUIDE TO THE CODE AND ITS PROVISIONS 4 (1988).
3. 243 F.3d 1254 (10th Cir. 2001).
4. 279 U.S. 151, 155 (1929) (holding "[t]he estate so far as may be is settled as of the date of the testator's death").
5. All statutory references and citations to sections in this comment are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), Title 26 of the United States Code.
6. *McMorris*, 243 F.3d at 1261 (emphasis added).
7. 232 F.3d 773 (10th Cir. 2000).
8. *St. Charles*, 232 F.3d at 779.

sonable business expenses. In *Eberl's Claim Serv., Inc. v. Commissioner*,[9] the Tenth Circuit rejected taxpayer corporation's invitation to adopt an "independent investor test," as recently embraced by other circuits,[10] in favor of *stare decisis*, reaffirming the use of the "multi-factor test of reasonable compensation" set forth in its prior decision, *Pepsi-Cola Bottling Co. v. Commissioner*.[11]

I. DATE-OF-DEATH VALUATION FOR DETERMINING INDIVIDUAL ESTATE TAX LIABILITY

A. *Background*

In 1916, the federal estate tax system was created in order to generate revenue for use in the United State's anticipated entry into World War I.[12] Since its adoption,[13] the federal estate tax system has taxed transfers of property at death, but has allowed deductions for all valid claims.[14] Included in those allowable deductions is § 2053(a)(3), which provides for "claims against the estate."[15] This statute originated in part from § 202 of the 1916 Act, which declared, "the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property."[16] Read in conjunction with the Ways and Means Committee of the House of Representatives' 1916 Report on § 203, which stated, "[i]n determining the value of the net or taxable estate, deductions for all valid claims against the estate are allowed,"[17] § 2053(a)(3) can be construed to mean that Congress intended a deductible claim to be fixed or valued at death.[18]

Contrary to this statutory interpretation and legislative history, the Commissioner of Internal Revenue ("Commissioner") has historically

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9. 249 F.3d 994 (10th Cir. 2001).

10. *Eberl's Claim*, 249 F.3d at 1003-04.

11. 528 F.2d 176 (10th Cir. 1976).

12. *See* WFT-CPET Ch. 17: *The Federal Gift and Estate Taxes*, 2001 WL 423593, at *2.

13. *See generally* Gary Robbins & Aldona Robbins, *The Case for Burying the Estate Tax*, Institute For Policy Innovation, Policy Report #150, at 1-7 (1999), *available at* www.ipi.org (discussing a historical overview of U.S. estate taxes and the developments of modern estate tax law by providing a chronology of legislation, a detailed description, and purpose for the legislation).

14. *See* Robert C. Jones, *Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death*, 22 UCLA L. REV. 654 n.3 (1975) (explaining that a "valid claim" includes "funeral expenses; administrative expenses; claims against the estate; mortgages or indebtedness on property included in the gross estate; certain state and foreign death taxes; casualty or theft losses incurred during settlement of the estate; public, charitable and religious contributions; and bequests to the surviving spouse" (citations omitted)).

15. Craig S. Palmquist, *The Estate Tax Deductibility of Unenforced Claims Against a Decedent's Estate*, 11 GONZ. L. REV. 707 (1976) (discussing how "claims against the estate" are "the personal obligations of the decedent existing at the time of death," which arise from a "contractual arrangement or by operation of law" and are "enforceable under local law").

16. *Id.* at 709 (quoting Revenue Act of 1916, ch. 463, § 202, 39 Stat. 77).

17. *Id.* (quoting H.R. REP. No. 922, 64th Cong., 1st Sess. (1916)).

18. *See id.* at 709-10.

advocated that "a deduction be allowed only for a claim *actually paid* by the estate and whose *value* is determined with accuracy, in light of all events *during the administration of the estate* [as opposed to date-of-death]."[19] Treasury Regulation § 20.2031--1(b) *defines* "value" to mean "fair market value" or "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts,"[20] however the Code fails to specify *how* to value property, so "[t]he method of valuation is determined from regulations, IRS rulings and case law."[21]

Commissioner's position also conflicts with the United States Supreme Court's adoption of the date-of-death valuation approach[22] set forth in its 1929 unanimous decision, *Ithaca Trust Co. v. United States*,[23] in which decedent's trustee, Ithaca Trust Company, sued the United States for recovery of taxes that were overpaid.[24] Under the terms of decedent's will, testator's wife received the residue of the estate for her life, and upon her death, the remainder passed in trust to certain charities.[25] Initially, testator's estate used mortality tables to calculate wife's life expectancy and thus arrive at the amount of the charitable deduction allowed for estate tax purposes.[26] This valuation method was called into question when wife died within six months of testator/husband.[27] Since wife "died before reaching her actuarial life expectancy,"[28] the United States argued that the actual date of wife's death applied in valuing the amount of the charitable deduction, which resulted in Ithaca Trust Company paying a higher estate tax.[29] The Court rejected the United States' argument and held in favor of Ithaca Trust Company paying a lower estate tax by calculating the charitable deduction "according to the wife's life expectancy [using mortality tables] as of the date of the *testator's* [husband's] death."[30] In reaching this conclusion, the Court explained, "[t]he estate so far as may be is settled as of the date of the testator's

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19. *Id.* at 709 (emphasis added).

20. ELAINE R. FORS ET AL., THE MARYLAND INSTITUTE FOR CONTINUING PROFESSIONAL EDUCATION OF LAWYERS, FEDERAL GIFT AND ESTATE TAX RETURNS Ch. IV, at I (2000).

21. *Id.*

22. The date-of-death valuation approach fixes the amount of the claims against the estate deduction at the date of decedent's death. *See* Palmquist, *supra* note 15, at 709. *See also McMorris*, 243 F.3d 1254, 1260 (10th Cir. 2001) (discussing how "events occurring after a decedent's death are irrelevant in valuing an estate's deduction under section 2053(a)(3)").

23. 279 U.S. 151, 155 (1929) (holding "[t]he estate so far as may be is settled as of the date of the testator's death").

24. *Ithaca Trust*, 279 U.S. at 153-54.

25. *Id.* at 154.

26. *Id.* at 155.

27. *Id.*

28. Robert Don Collier, *Survey Article: Federal Taxation*, 32 TEX. TECH. L. REV. 823, 827 (2001).

29. *See Ithaca Trust*, 279 U.S. at 155.

30. *McMorris*, 243 F.3d at 1259-60 (10th Cir. 2001) (emphasis added).

death."[31] Today, this pronouncement of the law as articulated by the Court more than 70 years ago retains its precedential effect, and is known as the "date-of-death valuation rule."[32]

With respect to the Tenth Circuit, the date-of-death valuation topic was one of first impression for the court when it agreed to hear *Estate of McMorris v. Commissioner*.[33] The issue for resolution was whether it was proper in calculating a § 2053(a)(3) deduction to consider post-death events.[34] Since § 2053(a)(3) was silent on the issue and the pertinent tax regulations provided no clear answer,[35] the Tenth Circuit was forced to rely on its own discretion in whether to distinguish the holding of *Ithaca Trust* or extend it to the facts of *Estate of McMorris*.

B. Tenth Circuit Case: *Estate of McMorris v. Commissioner*

1. Facts

Decedent's husband died in 1990, at which time decedent/wife inherited 13.409091 shares of NW Transport Service, Inc. stock.[36] The stock was appraised, at the date of decedent's husband's death, at a value of $1,726,562.50 per share.[37] Shortly thereafter, decedent/wife and NW Transport entered into a stock redemption agreement for $29.5 million, or approximately $2.2 million per share.[38] Meanwhile, the Commissioner of Internal Revenue issued a notice to decedent's husband's estate disputing the value of the NW Transport stock.[39] In January 1996, a settlement agreement was finalized between decedent husband's estate and the Commissioner, which *increased* the value of the NW Transport stock to $2.5 million per share (versus the original appraisal value of $1,726,562.50 per share in 1990).[40] Consequently, the capital gain of $473,437.50 [$2.2 million per share *minus* $1,726,562.50 per share] that decedent/wife had obtained from the stock redemption now resulted in a loss of $300,000 [$2.5 million per share *minus* $2.2 million per share], based on the new $2.5 million per share value set forth by the 1996 settlement agreement.[41] Given this loss realized from the NW Transport stock redemption, decedent/wife's estate filed an amended federal tax return requesting a $3,332,443 refund.[42] In dispute between dece-

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31. *Ithaca Trust*, 279 U.S. at 155.
32. *McMorris*, 243 F.3d at 1260.
33. 243 F.3d 1254, 1258 (10th Cir. 2001).
34. *McMorris*, 243 F.3d at 1258.
35. *Id.* at 1259.
36. *Id.* at 1256.
37. *Id.*
38. *Id.*
39. *Id.*
40. *McMorris*, 243 F.3d at 1256. (emphasis added).
41. *Id.*
42. *Id.*

dent/wife's estate and the Commissioner was whether the 1996 settlement agreement was relevant in determining the value of the § 2053(a)(3) deduction taken by decedent/wife's estate in its amended federal tax return.[43] The Commissioner argued the 1996 settlement agreement was relevant, while decedent/wife's estate argued it was not.[44]

2. Decision

The Tenth Circuit ruled in favor of decedent/wife's estate and extended the date-of-death valuation rule announced by the United States Supreme Court in *Ithaca Trust Co. v. United States*,[45] to the instant case, by holding that "events which occur *after* a decedent's death may *not* be considered in valuing" a § 2053(a)(3) claim against the estate deduction.[46] Thus, the 1996 settlement agreement was *not* relevant for purposes of calculating decedent/wife's estate tax liability.[47]

In reaching its conclusion, the Tenth Circuit explained that "[s]ound policy reasons" supported its adoption of the date-of-death valuation principle.[48] In particular, the court reasoned that the date-of-death valuation principle created a "bright line rule," which would alleviate "the uncertainty and delay in estate administration which may result if events occurring months or even years after a decedent's death could be considered in valuing a claim against the estate."[49] The court further explained that its "bright line rule" would achieve a longtime "ideal" of the legal community: bring "more certainty to estate administration."[50] However, in making this determination, the court attempted to dispel any signs of inherent favoritism such a bright line rule could create, by stating the rule could just as easily benefit the Commissioner, rather than the taxpayer/estate depending on "the particular circumstances of each case."[51]

Therefore, the Tenth Circuit created *new* precedent by recognizing the date-of-death valuation principle in calculating a § 2053(a)(3) deduction, which practitioners must now consider when valuing an individual decedent's estate and calculating that estate's tax liability for federal and state income tax purposes.

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43. *Id.* at 1258.

44. *Id.*

45. 279 U.S. 151, 155 (1929) (holding "[t]he estate so far as may be is settled as of the date of the testator's death").

46. *McMorris*, 243 F.3d at 1261 (emphasis added).

47. *Id.* at 1263 (emphasis added).

48. *Id.* at 1261.

49. *Id.* at 1261-62.

50. *Id.* at 1262.

51. *Id.*

C. *Other Circuits*

Despite the United States Supreme Court's unanimous pronouncement in *Ithaca Trust Co. v. United States*,[52] the circuits are split on their extension of the date-of-death valuation rule beyond charitable bequest deductions.[53]

1. Fifth, Ninth and Eleventh Circuits

In agreement with the Tenth Circuit are the Fifth, Ninth, and the Eleventh Circuits,[54] which *accept* the date-of-death valuation approach and *prohibit* the consideration of post-death events in valuing claims against the estate.

a. Fifth Circuit

In *Estate of Smith v. Commissioner*,[55] the decedent, prior to her death, was being sued by Exxon Corporation to recoup an overpayment of royalty proceeds that Exxon had made to decedent and other royalty owners of oil and gas leases.[56] Approximately fifteen months *after* decedent's death, decedent's estate settled the suit with Exxon for $681,840.[57] The Commissioner alleged that this settlement set the value of decedent's estate's § 2053(a)(3) deduction.[58] In a resounding rejection of this argument, the Fifth Circuit held that such post-death facts as the decedent's estate's settlement with Exxon should *not* be considered in valuing a § 2053(a)(3) deduction.[59] The court explained that "the claim generating the estate tax deduction under § 2053(a)(3) . . . must be valued as of the date of the death of the decedent and thus must [be] appraised on information known or available up to (but not after) that date."[60] In reaching this conclusion, the court reasoned that when the date-of-death valuation principle was announced by the United States Supreme Court in *Ithaca Trust Co. v. United States*,[61] it was making a determination about the general nature of the federal estate tax.[62] It is a tax imposed on transferred property that is levied at a discrete time (at death), so it makes sense that

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52. 279 U.S. 151, 155 (1929) (holding "[t]he estate so far as may be is settled as of the date of the testator's death").

53. *See McMorris*, 243 F.3d at 1260.

54. *See* cases cited *infra* notes 55, 66, 72. *See generally* 34 A. AM. JUR. 2D *Federal Taxation* § 144,210 (2002) (discussing the Fifth, Tenth, and Eleventh Circuits' mutual agreement regarding the broad application of *Ithaca Trust* in their own jurisdictions).

55. 198 F.3d 515, 517 (5th Cir. 1999).

56. *Smith*, 198 F.3d at 517.

57. *See id.* at 519 (emphasis added).

58. *See id.* at 526.

59. *See id.* at 517-18 (emphasis added).

60. *Id.* at 517.

61. 279 U.S. 151, 155 (1929).

62. *See Smith*, 198 F.3d at 524. *See also Ithaca Trust*, 279 U.S. at 155 (concluding that "the value of the thing to be taxed must be estimated as of the time when the act is done").

the value of the property transferred should be made at that same time.[63] The court further reasoned that since Congress has enacted statutory exceptions to the date-of-death valuation rule,[64] it knows how to derogate from the rule when it wants to, but to date, Congress has "never seen fit to overrule *Ithaca Trust* legislatively," so the courts should not either.[65]

b. Ninth Circuit

Likewise, in *Propstra v. United States*,[66] decedent's estate consisted primarily of two parcels of land, which at the time of his death, were encumbered by liens totaling $202,423.05.[67] Approximately three years *after* decedent's death, his estate settled the lien claims for $134,826.23.[68] The Commissioner alleged decedent's estate was only allowed to deduct the value of the settlement, or that amount actually paid in discharge of the liens, which was *less* than the value of the liens at the time of decedent's death.[69] In ruling in favor of decedent's estate, the Ninth Circuit held that "§ 2053[(a)(3)] precludes the consideration of post-death events in computing the value of certain and enforceable claims against an estate."[70] In reaching this conclusion, the court was persuaded by the teachings of *Ithaca Trust* and the language of Treasury Regulation § 20.2053-4, which "designates 'the time of death' as the critical reference point" for determining what amounts may be deducted as claims against an estate.[71]

c. Eleventh Circuit

Similarly, in *O'Neal v. United States*,[72] decedent's estate in seeking a $1,883,762 estate tax refund claimed it was entitled to a $9,407,226 deduction under § 2053(a)(3)[73] for reimbursement of nine heirs' "transferee gift tax liability" on stock gifts received from decedent,[74] prior to her death.[75] Upon decedent's death, a timely filing of her estate tax return was made, which was selected for audit by the government who challenged the § 2053(a)(3) deduction.[76] A settlement was reached some nine months after decedent's death, but decedent's estate was held liable for

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63. *See Smith*, 198 F.3d at 524.
64. *See, e.g.*, funeral expenses in § 2053(a)(1) and estate administration expenses in § 2053(a)(2). *See Smith*, 198 F.3d at 524.
65. *Smith*, 198 F.3d at 524.
66. 680 F.2d 1248 (9th Cir. 1982).
67. *Propstra*, 680 F.2d at 1250.
68. *See id.* at 1250 (emphasis added).
69. *See id.*
70. *Id.* at 1257.
71. *Id.* at 1255.
72. 258 F.3d 1265 (11th Cir. 2001).
73. *O'Neal*, 258 F.3d. at 1270.
74. *Id.* at 1271.
75. *Id.* at 1267.
76. *See id.* at 1268.

$1,883,762 in estate taxes because its § 2053(a)(3) deduction was reduced from $9,407,226 to $563,314.[77] While decedent's estate paid the increase in taxes, it then sought reimbursement by filing the above-mentioned tax refund claim.[78] The issue for resolution by the Eleventh Circuit was whether the post-death settlement, which was determined more than nine months after decedent's death, should influence the value of the estate's § 2053(a)(3) deduction.[79] Aligning itself with the Fifth and Tenth Circuits, the court held in favor of decedent's estate and concluded that limiting *Ithaca Trust* to only charitable bequests was erroneous.[80] Instead, the court determined that the better-reasoned and more persuasive approach was to extend *Ithaca Trust* to cases, such as this one, which involved § 2053(a)(3) deductions.[81] In such cases, the value of the § 2053(a)(3) deduction "must be valued as of the date of the decedent's death. All events occurring after the decedent's death that alter the value must be disregarded."[82] This included the $563,314 settlement amount arrived at *after* decedent's death, which therefore could *not* be considered in valuing the estate's § 2053(a)(3) deduction.[83]

2. Second and Eighth Circuits

In contrast, both the Second Circuit[84] and the Eighth Circuit[85] have *rejected* the date-of-death valuation approach and *allow* post-death events to be considered in valuing a § 2053(a)(3) deduction.

a. Second Circuit

In *Commissioner v. Estate of Shively*,[86] decedent/husband, prior to his death, entered into a separation agreement with his wife, which was later incorporated into their divorce decree that provided wife $40 a week in spousal support until her death or remarriage, and if decedent/husband died first, the weekly payments would be a charge upon his estate.[87] At the time of decedent/husband's death his wife had *not* remarried, but approximately one year *after* decedent's death, she did remarry.[88] Decedent/husband's estate paid wife her weekly support until the date of her remarriage.[89] However, when decedent's estate calculated

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77. *See id.*
78. *See id.*
79. *See O'Neal*, 258 F.3d at 1275.
80. *See id.* at 1273 n.25.
81. *See id.*
82. *Id.* at 1276.
83. *See id.* at 1275 (emphasis added).
84. *See* case cited *infra* note 86.
85. *See* case cited *infra* note 97.
86. 276 F.2d 372, 373 (2d Cir. 1960).
87. *Shively*, 276 F.2d at 373.
88. *See id.* at 373 (emphasis added).
89. *See id.*

its § 2053(a)(3) deduction [formerly § 812(b) deduction], it relied on wife's unmarried status as of decedent/husband's date of death.[90] This created an expectation of paying $27,058.30 for the duration of wife's life, based on the $40 a week charge to decedent's estate for her support.[91] Ruling in favor of the Commissioner, the Second Circuit held that the allowable deduction was limited to $2,079.96, or the amount of the payments wife had received from the date of decedent/husband's death to the date of her remarriage.[92] The court explained, decedent's estate may obtain "no greater deduction than the established sum, irrespective of whether this amount is established through events occurring before or after the decedent's death."[93] In reaching this conclusion, the court reasoned that to allow otherwise would defeat the purpose of the deduction, which was "to define that portion of the property of a decedent that is subject to estate tax."[94]

What is noteworthy about this decision is the attention it brings to the timing and order of events in an estate administration. As described by the dissent, the majority relied upon the "fortuitous circumstance" that the estate tax return was *not* filed until *after* wife had remarried.[95] Had the return been filed *before* wife's remarriage, or if wife had *not* remarried until a few years after the audit, there would have been no grounds for the Commissioner to challenge the estate's deduction.[96]

b. Eighth Circuit

Similarly, in *Estate of Sachs v. Commissioner*,[97] the decedent's estate paid income tax on a gift of stock included in the estate at the time of decedent's death.[98] Four years later, Congress passed the Tax Reform Act of 1984, which resulted in a full refund of the income tax that that's estate had paid on that gift of stock.[99] Consequently, decedent's estate attempted to use the original income tax it had paid on the gift of stock, prior to the refund, as a deduction and claim against the estate under § 2053(a)(3).[100] The estate argued that "since the estate's gross value was diminished by that amount at the time of Sach's death,"[101] and the refund did *not* occur until *after* decedent's date of death, it was entitled to the deduction.[102] In ruling in favor of the Commissioner, the Eighth Circuit

90. *See id.* at 374.
91. *See id.* at 375.
92. *See id.* at 374.
93. *Shively*, 276 F.2d at 375.
94. *Id.*
95. *Id.* (emphasis added).
96. *See id.* at 376 (emphasis added).
97. 856 F.2d 1158, 1159 (8th Cir. 1988).
98. *Sachs*, 856 F.2d at 1159.
99. *See id.* at 1159.
100. *See id.* at 1159-60.
101. *Id.* at 1158.
102. *Id.* at 1160 (emphasis added).

held that the estate could *not* deduct under § 2053(a)(3), "an income-tax liability which was subsequently forgiven by Congress."[103] The court explained, "an estate loses its § 2053(a)(3) deduction for any claim against the estate which ceases to exist legally, regardless of whether the nullification of the claim could have been foreseen."[104] In reaching this conclusion, the court reasoned that Congress intended the § 2053(a)(3) deduction to accommodate actual claims, those claims already paid or to be paid, rather than just theoretical claims.[105] The court further determined that *Ithaca Trust* was distinguishable and therefore *not* controlling on the grounds that the date-of-death valuation principle enunciated by the Supreme Court was intended to apply only in the narrow context of charitable bequests, which this case was not.[106]

D. *Analysis*

While the Tenth Circuit attributes its holding to a desire to avoid uncertainty and delay in estate administration by adopting a "bright line rule,"[107] one must question whether the advantages of such a strict rule really outweigh the unfairness that can result[108] when a court is unable to exercise flexibility. The practicality of the Tenth Circuit's holding is also questionable with regard to its ability to effectively avoid the uncertainty and delay that all practitioners filing an estate tax return know: every return is subject to audit and every estate has the potential of being dragged out for years before a closing letter is received.[109] Likewise, practitioners know that when a deficiency notice is issued, there are typically several different issues, not just one.[110] Therefore, "[i]t is unlikely that a post-death event would be the sole cause of delay."[111] When the Tenth Circuit's holding is viewed in this light, allowing the valuation of post-death events does *not* seem to create the hardship the court suggests.[112] As one team of commentators has observed, more fairness would be achieved if, instead of the current distinction between date-of-death and post-death valuation, the cases were distinguished based on situations where the final adjustments were due to factors *out of* the estate's control (such as audits or tax law changes) versus factors *within* the

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103. *Id.* at 1159 (emphasis added).

104. *Sachs*, 856 F.2d at 1161.

105. *See id.* at 1160.

106. *See id.* at 1162.

107. *McMorris*, 243 F.3d at 1261.

108. *See* Robert E. Madden & Lisa H.R. Hayes, *Estate Tax Deduction Not Altered By Post-Death Events, Rules CA-10 Estate of McMorris*, 28 EST. PLAN. 325, comments (2001).

109. *See id.*

110. *See id.*

111. *Id.*

112. *See id.* (emphasis added).

estate's control (such as choosing to increase liability in order to eliminate future obligations).[113]

In addition, the Tenth Circuit's reassurance that this "bright line rule" can just as easily benefit the government, as it does the estate,[114] rings hollow in light of the fact that the Commissioner has historically argued *against* the date-of-death valuation approach more often than not.[115] Consequently, this unconvincing statement by the court leads one to conclude the professed fairness of the "bright line rule" is a sham and in reality the rule weighs in favor of the estate more frequently than the government.[116]

To make matters worse, by all indications, the split in the circuits regarding date-of-death valuation is irreconcilable.[117] The only way to resolve the conflict of whether *Ithaca Trust* should be read as broadly as the Fifth, Ninth, Tenth and Eleventh Circuits have done, or if instead it should be construed as narrowly as the Second and Eighth Circuits have done, is for Congress to enact specific legislation addressing the issue.[118] Until that time, practitioners would be well advised to check the precedent of their local circuit court and be prepared to advise a client whether or not to challenge a valuation of a post-death event depending upon the approach adopted by their jurisdiction.[119]

II. DEDUCTIBILITY OF SUSPENDED "PALS" CARRIED FORWARD TO AN S CORPORATION

A. *Background*

As a result of Congress's perception that taxpayers were eroding federal tax revenues by using losses from one activity to offset taxable income from another activity, the passive activity loss rules were

113. *See id.* (emphasis added).

114. *McMorris*, 243 F.3d at 1262.

115. *See* Palmquist, *supra* note 15, at 709 (emphasis added).

116. *See id.*

117. *See* Estate of Smith v. Comm'r, 198 F.3d 515, 522 (5th Cir. 1999). *See also* Estate of Van Horne v. Comm'r, 78 T.C. 728, 736-37 (1982) (explaining how "all of the cases in this field dealing with post-death evidence are not easily reconciled with one another, and at times *it is like picking one's way through a minefield* in seeking to find a completely consistent course of decision in this area") (emphasis added).

118. *See, e.g.*, Robert C. Jones, *Estate and Income Tax: Claims Against the Estate and Events Subsequent to Date of Death*, 22 UCLA L. REV. 654, 682 (1975) (encouraging Congress to aid the executor by "providing a more definitive statement of valuation dates").

119. *See* Madden & Hayes, *supra* note 108. Nevertheless, while it is beyond the scope of this comment, some recourse exists for preparers of estate tax returns by utilizing Code § 2032 or "protective alternate valuation election (PAVE)," which "allows an executor to use the alternate values and recalculate a lower tax after the return is filed -- even if the date-of-death values are used when the return is initially filed." S. Dresden Brunner & Laird A. Lile, *PAVE -- A Self-Help Technique For Estate Tax Valuation Methods*, 75-Oct. FLA. B.J. 44, 44 (2001).

created.[120] While the legislative history reveals that several alternative methods were considered, Congress adopted a system whereby "business losses would only be permitted to offset nonbusiness income (*e.g.*, wages and interest) if the taxpayer *materially participated* in the business that generated the loss."[121] Congress established this "material-participation" standard in order to "prevent taxpayers from basing their investment decisions primarily upon the tax benefits they would receive."[122] Consequently, a passive activity is "any business in which the taxpayer does *not* materially participate;" or, in other words, the taxpayer is *not* involved in the activity on a regular basis.[123]

In general, the passive activity restrictions in § 469 "prevent a taxpayer who is *not* actively involved in a business from deducting losses from the business as an offset against compensation . . . or . . . portfolio investments."[124] However, § 469(c) defines real estate rental activity as a *per se* passive activity "without regard to the taxpayer's level of participation in the activity."[125] Passive activity losses ("PALs") occur when "the amount, if any, by which the passive activity *deductions* for the taxable year *exceed* the passive activity *gross income*."[126] For example, if a corporation has total gross income from its real estate rental activities (passive activities) of $400,000, but it has total deductions from those same real estate rental activities of $600,000, the corporation will sustain PALs of $200,000. Typically, under § 469(a) of the Code, PALs are *not* deductible.[127] However, § 469(b) provides that "PALs can be suspended and 'carried forward' to the following year" and after application of § 469(b)'s carry-over provision, under § 469(g)(1)(A), any remaining PAL "shall be treated as a non-passive loss."[128]

With respect to the Tenth Circuit, the deductibility of suspended PALs carried forward to an S corporation was a topic of first impression for the court when it agreed to hear *St. Charles Inv. Co. v. Commissioner*.[129] The issue for resolution was whether it was proper for the Commissioner to disallow the carry-over of suspended PALs by an S corporation, which had incurred the PALs while it was a C corporation.[130]

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120. *See* NEIL A. RINGQUIST, WORKING WITH THE REVISED PASSIVE ACTIVITY LOSS RULES 5 (1995).
121. *Id.* (emphasis added).
122. *Id.*
123. PEEL, *supra* note 2, at 231 (emphasis added).
124. *Id.* at 230 (emphasis added).
125. RICHARD M. LIPTON ET AL., PASSIVE ACTIVITY LOSSES § 603 (1995).
126. *Id.* at § 1202 (emphasis added).
127. *See id.* at § 1207.1.
128. St. Charles Inv. Co. v. Comm'r, 232 F.3d 773, 774 (10th Cir. 2000).
129. *St. Charles*, 232 F.3d at 775.
130. *See id. See generally* I. RICHARD GERSHON, A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE 6-7 (4th ed. 1999) (discussing the Code's different corporate tax treatments and explaining how "S" corporations and "C" corporations received their names as a result of the Code

Since this was an issue undecided by any other circuit, the Tenth Circuit relied on its own discretion when interpreting the congressional intent and statutory language of the provisions in question.

B. Tenth Circuit Case: *St. Charles Inv. Co. v. Commissioner*[131]

1. Facts

From 1988 to 1990, St. Charles operated as a closely held C corporation engaged in real estate rental activities (*i.e.*, "passive activities").[132] In 1991, St. Charles changed its tax status to an S corporation[133] and sold some of its rental properties, which had suspended PALs associated with them for the years when St. Charles operated as a C corporation.[134] St. Charles then identified those suspended PALs, totaling $6,038,001, on its 1991 tax return and claimed them as deductions as authorized by § 469(g)(1)(A).[135] In 1996, the Commissioner issued a notice of adjustment *disallowing* St. Charles' use of its suspended PALs based on § 1371(b)(1), which "prohibits an S corporation from carrying any 'carry-forward' from a year in which the corporation was a C corporation to a year in which the corporation is an S corporation."[136] In dispute was the conflict between the two carry-over provisions of § 469(b) and § 1371(b)(1).[137]

2. Decision

The Tenth Circuit ruled in favor of St. Charles and held that when a taxpayer corporation changes its status from a C corporation to an S corporation, it is permissible to carry forward the suspended PALs, incurred during the years it was a C corporation, to the year it became an S corporation, and fully deduct those suspended PALs.[138] The court explained by implementing the rules of statutory construction, the "except as otherwise provided" language of § 469(b)[139] prevented any exceptions *not*

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setting forth the requirements for each type of corporation in Subchapter S and Subchapter C, respectively).

131. 232 F.3d 773 (10th Cir. 2000).

132. *See St. Charles*, 232 F.3d at 774.

133. The Code treats such corporations in a special fashion in that "[t]he income or loss to an S corporation flows through to the shareholders" providing "the advantages of the corporate form without double taxation." PETER C. KOSTANT, BUSINESS ORGANIZATIONS: PRACTICAL APPLICATIONS OF THE LAW 86 (1996). In contrast, a C corporation is taxed on its profits and the shareholders are taxed on any corporate dividends they receive, which results in double taxation. *See id.* at 85.

134. *See St. Charles*, 232 F.3d at 774.

135. *See id.*

136. *Id.* at 775.

137. *See id.* at 776.

138. *See id.* at 779.

139. Specifically, § 469(b) states: "*Except as otherwise provided in this section*, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or

expressly stated in § 469(b) from applying, which included § 1371(b)(1)'s restrictions[140] on carry forwards from a C year to an S year.[141] In reaching this conclusion, the court reasoned that Congress intended § 469(b) to be interpreted in this way because the plain language of § 469(f)(2)[142] allowed "the application of § 469 to a corporation's PALs *even after it ceases to be* a closely held C corporation."[143] The court further determined that while its decision created a "windfall in favor of the shareholders of St. Charles, effectively allowing one taxpayer (the shareholder) to offset his income with the losses of a different taxpayer (the corporation)," the result was warranted because the statutory text of § 469 unequivocally supported it.[144]

C. *Other Circuits*

As of the survey period (September 1, 2000 – August 31, 2001), no other circuits had considered this issue.[145]

D. *Analysis*

Unlike *McMorris*, where the Tenth Circuit *denied* that its extension of date-of-death valuation would create unfairness by always favoring the taxpayer/estate,[146] in *St. Charles*, the Tenth Circuit openly admitted that its holding would create a windfall for the taxpayer.[147] Yet, the Tenth Circuit justified the windfall in *St. Charles* as valid because there existed "unequivocal support for such a result in the statutory text."[148] While one can understand how the "unequivocal support" standard provides the minimum floor for which the court must comply, it is less clear why the court is unwilling to exercise its powers of equity to recalibrate the windfall that exists. One can speculate that more was driving the court than just strict compliance with the rules of statutory construction, such as common sense. A common sense evaluation of the case points out that St. Charles was still the *same* company, engaged in the *same* activities in

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credit allocable to such activity in the next taxable year." 26 U.S.C. § 469(b) (2001) (emphasis added).

140. In particular, § 1371(b)(1) provides that "[n]o carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation." 26 U.S.C. § 1371(b)(1) (2001).

141. *See St. Charles*, 232 F.3d at 775, 777 (emphasis added).

142. Specifically, § 469(f)(2) states: "If a taxpayer ceases for any taxable year to be a closely held C corporation . . . this section shall continue to apply to losses . . . to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation." *St. Charles*, 232 F.3d at 778 (quoting 26 U.S.C. § 469(f)(2) (2001)).

143. *St. Charles*, 232 F.3d at 778 (emphasis added).

144. *Id.* at 779.

145. *See id.* at 775.

146. *See supra* text accompanying note 51.

147. *See St. Charles*, 232 F.3d at 779.

148. *Id.*

1991 as it was in 1988,[149] and it had merely elected for different tax treatment under a different chapter of the Code: subchapter S, rather than subchapter C of chapter 1.[150] Viewed in this light, the result achieved by the court in *St. Charles* is both reasonable and distinguishable from *McMorris*, where the court was dealing with a situation that was *not* the same, because the settlement agreement was executed *after* the decedent's death, by parties other than the decedent himself.

III. TEST FOR DETERMINING THE DEDUCTIBILITY OF SALARIES BY A CORPORATION AS REASONABLE BUSINESS EXPENSES

A. *Background*

Pursuant to § 162(a)(1), a taxpayer corporation is authorized to deduct a "reasonable allowance for salaries and other compensation"[151] of its employees as an "ordinary and necessary business expense."[152] However, several "suspect situations" exist in which the Commissioner is more likely to challenge an employee's salary as excessive,[153] such as when "the payor and payee are related parties"[154] or the related taxpayers' "economic interests are essentially identical" [155] and income-shifting is occurring, as in closely held corporations.[156] It is within this context of closely held corporations that the rationale for the reasonableness limitation is particularly evident.[157] Absent the reasonableness limitation, income-shifting would occur in the form of the employer-corporation paying an excessive salary to its controlling shareholder (who also serves as the corporation's executive so that "the corporation is practically a one-person company"),[158] which is deductible to the employer-corporation, in lieu of paying a dividend to the shareholder-executive, which is not deductible to the employer-corporation.[159] As a result, the corporation shifts the income that was due and owing to the shareholder-executive away from itself by not paying a dividend and reduces its own tax liability by the dollar-amount of the shareholder-executive's compen-

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149. *See id.* at 774.

150. *See* PEEL, *supra* note 2, at 186.

151. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 117 (3d ed. 1982).

152. DANIEL Q. POSIN, FEDERAL INCOME TAXATION OF INDIVIDUALS WITH DIAGRAMS FOR EASY UNDERSTANDING OF THE LEADING CASES AND CONCEPTS ¶ 6.03(2)(a) (4th ed. 1998).

153. DANIEL Q. POSIN, FEDERAL INCOME TAXATION OF INDIVIDUALS AND BASIC CONCEPTS IN THE TAXATION OF ALL ENTITIES 321 (Student ed. 1983).

154. For example, "corporation and shareholder or as members of the same family--so that the 'overpayment' actually entails no economic loss to the employer." CHIRELSTEIN, *supra* note 151, at 117.

155. *Id.* at 118.

156. *See id.*

157. *See id.*

158. TIMOTHY P. BJUR & DENNIS JENSEN, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2129.10 (1995).

159. *See* CHIRELSTEIN, *supra* note 151, at 118.

sation.[160] Of course, since the shareholder-executive's "economic interests are essentially identical" to the closely held corporation's[161] (*i.e.*, pay as little tax to the Commissioner as possible by reducing "their total tax burden"),[162] without the reasonableness limitation, the choice to pay an excessive salary rather than a dividend[163] would result in great revenue losses to the Commissioner.

Thus, in the event the Commissioner is successful in proving an executive's salary is excessive, the executive can still get paid, however the salary will be "disallowed" and "recharacterized as a dividend," which is taxable to the executive as income arising from his role as shareholder, but is not deductible by the corporation as a reasonable business expense.[164] Throughout the dispute, the burden of proof remains with the taxpayer asserting the compensation is "reasonable."[165]

With regard to federal circuit court law on this topic of reasonable compensation, there is a vast body of established law.[166] However, as the topic relates to the Tenth Circuit, one specific approach, the "multi-factor test," was adopted in 1976 in *Pepsi-Cola Bottling Co. v. Commissioner*,[167] and it provides nine factors to consider when determining whether a salary is "reasonable."[168] In *Eberl's Claim Serv., Inc. v. Commissioner*,[169] the Tenth Circuit was confronted with the decision of whether to continue its use of the "multi-factor test" or adopt the "independent investor test," as recently embraced by other circuits.[170]

B. Tenth Circuit Case: *Eberl's Claim Serv., Inc. v. Commissioner*

1. Facts

Taxpayer corporation, a closely held Colorado claims adjusting company, provided independent claims adjuster's services to insurance companies following major disasters.[171] Eberl was the corporation's founder, president, sole shareholder and claims adjuster.[172] While a 1988 employment agreement existed between Eberl and taxpayer corporation, Eberl's salary or a formula for its computation was *not* specified.[173] A

160. *See id.*
161. *Id.*
162. POSIN, *supra* note 153, at 365.
163. *See* CHIRELSTEIN, *supra* note 151, at 119.
164. *Id.*
165. *See* Kurzet v. Comm'r, 222 F.3d 830, 834 (10th Cir. 2000).
166. *See* discussion *infra* Part III.C.
167. 528 F.2d 176, 179 (10th Cir. 1976).
168. *Eberl's Claim*, 249 F.3d at 999.
169. 249 F.3d 994 (10th Cir. 2001).
170. *Eberl's Claim*, 249 F.3d at 1003.
171. *See id.* at 996.
172. *See id.*
173. *See id.* (emphasis added).

1992 amendment to the agreement also did *not* fix the amount of Eberl's compensation, but did loosely tie his salary to gross revenues.[174] The only other employees receiving regular salaries were part-time clerical staff.[175] At no time during taxpayer corporation's existence were dividends paid.[176] Taxpayer corporation's gross receipts typically ranged from $2 million to $4 million, but sharp inclines were recorded in 1992 ($20,438,803) and 1993 ($9,168,585) based on the large number of major catastrophes in those years.[177] Consequently, Eberl's salary was significantly higher in those years: $4,340,000 for 1992 and $2,080,000 for 1993 (versus $190,000 to $608,000 in prior years).[178] When taxpayer corporation attempted to claim Eberl's salary as a deductible business expense, the Commissioner objected to Eberl's 1992 and 1993 salaries as "excessive."[179] The issue before the Tenth Circuit was whether Eberl's salaries in 1992 and 1993 were "reasonable," or whether they in fact constituted disguised dividend payments that should have been taxed.[180]

2. Decision

The Tenth Circuit ruled in favor of the Commissioner and rejected taxpayer corporation's invitation to adopt an "independent investor test," as recently embraced by other circuits,[181] in favor of *stare decisis* by reaffirming the use of the "multi-factor test of reasonable compensation" set forth in its prior decision, *Pepsi-Cola Bottling Co. v. Commissioner*.[182] The court explained that a compensation plan is considered "reasonable" if it is a result of a "longstanding, consistently applied plan negotiated at arm's length."[183] Here, it was not. No written documentation that a formula for calculating Eberl's salary existed[184] and even if such formula had existed, it was not negotiated at arm's length since Eberl was both controlling shareholder and employee.[185] Moreover, Eberl's salary was not determined until the end of each year, once taxpayer corporation's expenses were known, which enabled Eberl to receive virtually all of the corporation's net profits as compensation (not taxable) in lieu of paying a dividend (taxable).[186] Under the totality of these circumstances, the court concluded Eberl's salary was unreasonable and "a disguise for non-deductible profit distributions,"[187] on which taxpayer corporation had a

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174. *See id.* at 996-97 (emphasis added).
175. *See id.* at 997.
176. *See Eberl's Claim*, 249 F.3d at 997.
177. *See id.*
178. *See id.*
179. *Id.* at 996.
180. *See id.*
181. *See id.* at 1003-04.
182. 528 F.2d 176 (10th Cir. 1976).
183. *Eberl's Claim*, 249 F.3d at 1000.
184. *See id.* at 1000 n.2.
185. *See id.* at 1000.
186. *See id.*
187. *Id.*

duty to pay taxes.[188] In reaching this conclusion, the court acknowledged that while the "independent investor test"[189] had the potential to provide a simpler and more purposive solution than the multi-factor approach, it was bound, absent en banc rehearing, to adhere to the totality of the circumstances/multi-factor approach adopted in *Pepsi-Cola Bottling*.[190]

C. *Other Circuits*

Among the other circuits which have agreed with the Tenth Circuit that a multi-factor test is best to use in determining the reasonableness of salaries, there is variation in the actual number of factors that must be satisfied.[191] For example, the Tenth Circuit's *Pepsi-Cola Bottling* case[192] lists nine factors,[193] as does the Sixth Circuit, as set forth in *Mayson Mfg. Co. v. Commissioner*,[194] but the Fifth Circuit applies only eight factors, as listed in *Owensby & Kritikos, Inc. v. Commissioner*.[195] Despite these quantitative discrepancies in the factors employed by the above circuits to determine reasonableness of salary, in the end, they all employ a form of balancing the totality of the circumstances, rather than focusing on just one dispositive issue.

In contrast, of those circuits that have adopted the "independent investor test,"[196] only the Seventh Circuit in *Exacto Spring Corp. v.*

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188. *See id.* at 1002.

189. Specifically, the independent investor test asks, "whether an inactive, independent investor would be willing to compensate the employee as he was compensated." *Eberl's Claim* 249 F.3d at 1003 (quoting Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245 (9th Cir. 1983)).

190. *Eberl's Claim*, 249 F.3d at 1003-04.

191. *See id.* at 999.

192. Pepsi-Cola Bottling Co. v. Commissioner, 528 F.2d 176, 179 (10th Cir. 1976). Those nine factors are:

(1) [t]he employee's qualifications; (2) [t]he nature, extent and scope of the employee's work; (3) [t]he size and complexities of the business; (4) [a] comparison of salaries paid with the gross income and the net income; (5) [t]he prevailing general economic conditions; (6) [a] comparison of salaries with distributions to stockholders; (7) [t]he prevailing rates of compensation for comparable positions in comparable concerns; (8) [t]he salary policy of the taxpayer as to all employees; [and] (9) [i]n the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

Id. at 179.

193. *See Eberl's Claim*, 249 F.3d at 999.

194. 178 F.2d 115, 119 (6th Cir. 1949) (employing identical factors as the 10th Circuit in *Pepsi-Cola Bottling Co.*).

195. 819 F.2d 1315, 1323 (5th Cir. 1987) (applying the same factors as the 6th Circuit in *Mayson Mfg. Co.*, except for factor (9), which was not relevant, "[b]ecause the taxpayers have not argued that the payments in the years at issue were made in recompense for underpayments in previous years").

196. *See, e.g.*, Dexsil Corp. v. Comm'r, 147 F.3d 96, 100-201 (2d Cir. 1998) (explaining how the independent investor test "is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed"); Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245 (9th Cir. 1983) (applying a multi-factor test "from the perspective of an independent investor"); and Rapco, Inc. v. Comm'r, 85 F.3d 950, 954-55 (2d Cir. 1996) (same). *See also Eberl's Claim*, 249 F.3d at 1003.

Commissioner[197] has completely rejected the multi-factor test.[198] The Seventh Circuit in adopting the "independent investor test" held that the CEO's "'exorbitant' salary (as it might appear to a judge or other modestly paid official)" was "presumptively reasonable" because the investors in the company were "obtaining a far higher return than they had any reason to expect."[199] The court explained this result was justified, hence the qualifying language "presumptively reasonable," as long as the higher rate of return being generated was due to the CEO's own exertions, and not someone else's.[200] In reaching this conclusion, the court reasoned that by tying salary to performance, executive retention was encouraged because "killing the goose that lays the golden egg"[201] would not be good business for the company or its investors. In addressing the inadequacies associated with the multi-factor test, the court explained that "judges are not competent to decide what business executives are worth,"[202] and yet that is exactly what the multi-factor test requires judges to do. In particular, the court criticized the lack of directive provided by the multi-factor test in that "[n]o indication is given of how the factors are to be weighed in the event they don't all line up on one side."[203] The court explained that such an imbalance is resolved by a judge using his own discretion and his "own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of business should pay abnormally high (or low) salaries, and so forth."[204] The court further explained that since judges are neither trained nor experienced in such industry-specific matters, and the multi-factor "test cannot itself determine the outcome of a dispute because of its nondirective character," the results are arbitrary.[205] As a result, corporations have no uniform guidance from the law when it comes to determining executive compensation, and this lack of predictability creates expensive and unavoidable legal risks for the corporation.[206] As a replacement for the "redundant, incomplete, and unclear"[207] multi-factor test, the court proposed that the "independent investor test" provided a more logical and fair approach to determining executive salaries by, in essence, allowing the supply and demand needs of the market dictate, like other prices, what was reasonable.[208] This supply and demand approach is reflected in whether the corporation, through the efforts of its executives surpasses the investors' expectations of return on their in-

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197. 196 F.3d 833, 838 (7th Cir. 1999).
198. *See Eberl's Claim*, 249 F.3d at 1004 n.6.
199. *Exacto Spring*, 196 F.3d at 839.
200. *Id.*
201. *Id.* at 838.
202. *Id.*
203. *Id.* at 835.
204. *Id.*
205. *Exacto Spring*, 196 F.3d at 839.
206. *See id.*
207. *Id.* (quoting Palmer v. City of Chicago, 806 F.2d 1316, 1318 (7th Cir. 1986)).
208. *See id.* at 836, 838.

vestment in the corporation.[209] When an executive achieves a higher rate of return than investors expect, he can command a greater salary, which in turn, is an incentive for the executive to stay with the corporation and continue to make it profitable for the investors, allowing everyone to win.[210]

D. Analysis

In *McMorris*, the Tenth Circuit expressly announced favoritism for the date-of-death valuation method because it offered all of the advantages of a "bright line rule."[211] Yet, when the Tenth Circuit was presented with the opportunity to adopt the "independent investor test" in *Eberl's Claim*, which is clearly more of a "bright line rule" than the multi-factor test, the court declined to do so.[212] While this decision is attributable to the court's desire to conform to the principle of *stare decisis*, there are two hints that the court is leaving the door open for future consideration of the "independent investor test." First, the Tenth Circuit's remark that "absent en banc rehearing" it must conform with its prior precedent in *Pepsi-Cola Bottling*, suggests the inclusion of such a statement means the court may consider changing to the "independent investor test" if given the opportunity for an en banc rehearing.[213] Second, and perhaps providing more convincing evidence is the court's acknowledgement that the "independent investor test is an attractive solution."[214] For the numerous reasons articulated by Chief Judge Posner in *Exacto Spring Corp. v. Commissioner*,[215] the more simplified "independent investor test" is a convincing approach for determining the reasonableness of salaries by eliminating the arbitrary and unpredictable decisions arising from a court's free exercise of judicial discretion in an area it has no experience: the private, for-profit, corporate world.[216]

CONCLUSION

In general, tax law is substantially driven by statutes and IRS regulations, which limit courts in their interpretations. Typically, the rules for statutory construction are strictly complied with leaving little room for courts to exercise flexibility or make changes in the law without receiving criticism. Thus, it is no surprise that while the Tenth Circuit was willing over the past survey period of September 1, 2000 through August 31, 2001, to adopt some *new* tax law in cases of first impression: that is, the date-of-death valuation in *McMorris* for determining individual estate

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209. *See id.* at 838-39.
210. *See id.* at 838.
211. *See supra* text accompanying notes 50-51.
212. *See Eberl's Claim*, 249 F.3d at 1003.
213. *Id.*
214. *Id.* at 1003.
215. 196 F.3d 833 (7th Cir. 1999). *See supra* text accompanying notes 198-211.
216. *See supra* text accompanying notes 198-211.

tax liability; and the deductibility of suspended passive activity losses ("PALs") carried forward to an S corporation in *St. Charles*; the Tenth Circuit was less willing to depart from the principle of *stare decisis* and make changes to past holdings. For example, the Tenth Circuit's refusal in *Eberl's Claim* to join the bandwagon established by other circuits in adopting the "independent investor test," as a "new" test for determining the reasonableness of executive salaries.

Therefore, attorneys practicing within the Tenth Circuit's jurisdiction would be well advised to embrace the court's past decisions and not expect a change in tax law, unless the case presents a topic of first impression and the Tenth Circuit is required to rely on its own discretion, rather than just rules of statutory construction, to arrive at its decision.

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