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TAXATION

OVERVIEW

The Tenth Circuit Court of Appeals considered a limited number of federal taxation cases during the period covered by this survey. This overview will provide a brief summary of some of the published cases.[1]

I. CONSTRUCTIVE DIVIDENDS

In *Dolese v. United States*,[2] the issue before the Tenth Circuit Court of Appeals was whether the costs of litigation, paid by a corporate taxpayer in a divorce proceeding, were deductible. The case arose out of suits brought by Roger Dolese, the Dolese Company (TDC), and Dolese Concrete Company (DCC) to obtain income tax refunds in the amount of $1.5 million.[3] These suits, in turn, flowed from the divorce proceeding of Roger and Ardith Dolese. The divorce action began in 1957 and culminated nine years later. The divorce litigation costs, including $1.3 million in fees and expenses, were paid by Roger Dolese and the companies.

The divorce petition had named TDC, a company wholly owned by Roger Dolese, and DCC, a company which in turn was wholly owned by TDC, as party defendants. Also named as a defendant was the Dolese Brothers Company, which had been wholly owned by Roger Dolese and TDC, but was liquidated in 1970 and thereafter operated as a partnership between Dolese and TDC. In the divorce petition, Dolese was accused "of threatening to deplete and dissipate the assets of the companies in order to deprive Ardith of her rights as wife."[4] Ardith Dolese sought an order to prevent Dolese and the companies from engaging in any unusual business

1. Also published were:

United States v. Wase, 608 F.2d 400 (10th Cir. 1979), in which the Tenth Circuit held that Congress, not the court of appeals, has the power to declare what is legal tender. The court held that taxpayers may not value earnings in terms of gold dollars as a means of determining the need to file an income tax return.

Portland Cement Co. v. Commissioner, 614 F.2d 724 (10th Cir. 1980), in which the Tenth Circuit held that a miner manufacturer's first marketable product was bulk cement. The court ruled that the expenses associated with bagging the cement could not be considered mining costs and, therefore, could not be used to reduce the depletion deduction. The United States Supreme Court has recently granted certiorari to determine: 1) if the costs of bags, bagging, storage, distribution, and sales should be included as nonmining costs, and 2) if bulk cement or if both bulk and bagged cement constitute the first marketable product for purposes of computing gross income from mining where the "proportionate profits method" is used. 49 U.S.L.W. 3212 (U.S. Oct. 6, 1980) (No. 79-1907).

Stahmann Farms, Inc. v. United States, 624 F.2d 958 (10th Cir. 1980), in which the Tenth Circuit held that airplanes, which used only the taxpayer's private landing strip and flew only over the taxpayer's property, were subject to the "use" tax of I.R.C. § 4491, since the planes were operated within the statutorily defined navigable airspace.

2. 605 F.2d 1146 (10th Cir. 1979), *cert. denied*, 100 S. Ct. 1647 (1980).

3. The case had been before the Tenth Circuit in 1976. It was remanded to the trial court, where summary judgment was entered for the United States. *See* Dolese v. United States, 541 F.2d 853, 854 (10th Cir. 1976).

4. 605 F.2d at 1149.

activities. Early in the divorce litigation, the court ordered the companies not to pay investigative expenses.[5] In 1967, Ardith Dolese filed a motion alleging that her husband was incompetent and requesting that she be appointed to take his place in the management of the companies. In late 1968, this motion was denied.[6]

Ultimately, the state trial court issued orders requiring Dolese and the three companies each to pay one-fourth of the legal fees and expenses stemming from the divorce action. The state court reasoned that the legal proceeding was not just a divorce action, but was also a struggle for control of the companies. TDC and DCC sought to deduct their respective shares of the litigation expenses and fees as ordinary and necessary business expenses.[7] The United States, however, contended that these payments were actually constructive dividends paid to Dolese and, as such, were not deductible expenses.[8]

The Tenth Circuit court used the "origin of the claim" test to determine whether the costs of litigation were indeed ordinary and necessary business expenses.[9] The court of appeals divided the previous litigation into two categories, finding both a divorce action and an action against the companies. The court concluded that most of the expenses had their origin in the divorce action and, therefore, the litigation costs were not deductible.[10]

The Tenth Circuit went on to rule that the costs of obtaining clarification of the court order and the costs of resisting the motion to oust Dolese were deductible.[11] These expenses were found to have originated in the business activities of the companies. The court remanded the case to the trial court for a determination of the deductible amounts. The nondeductible expenses of litigation, representing "some direct benefit" to Dolese, were held to be constructive dividends.[12]

The court of appeals also considered whether a series of payments, totalling over $150,000, made by the companies to discharge Dolese's personal debts, were loans or constructive dividends. The Tenth Circuit court noted that although some loan attributes were present,[13] the debt was too large to be liquidated without the sale of one of the companies. Consequently, the payments were deemed to be constructive dividends.[14]

5. *Id.* By mid-1967, Dolese had spent at least $350,000 investigating Ardith's infidelities and her children's paternity.

6. *Id.*

7. I.R.C. § 162(a).

8. 605 F.2d at 1149.

9. "[T]he origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not . . . ." United States v. Gilmore, 372 U.S. 39, 49 (1963). *See also* Woodward v. Commissioner, 397 U.S. 572 (1970).

10. 605 F.2d at 1151-52.

11. *Id.*

12. *Id.* at 1152.

13. *Id.* at 1153. Appellants argued that the advances were loans because "notes were given . . . , interest was paid, some payments were made on the principal, and the shareholder [Dolese] had a balance sheet strong enough to obtain a bank loan sufficient to pay off the entire loan." *Id.*

14. *Id.* at 1154.

II. Industrial Development Bonds

The Tenth Circuit, in *Kirkpatrick v. United States*,[15] considered whether the interest derived from bonds issued by the Oklahoma Industries Authority, an agency of the State of Oklahoma, was subject to tax as gross income. Plaintiff Kirkpatrick purchased $175,000 worth of bonds issued by the Oklahoma Industries Authority, but did not include the interest from these bonds as gross income on her 1973 and 1974 income tax returns. The Commissioner of Internal Revenue (IRS) assessed deficiencies, which the taxpayer paid. When her suit for refund was dismissed by the district court, the taxpayer appealed to the Tenth Circuit.

The money raised by the bond issue was used to construct an office building which was subsequently leased to Mercy Hospital, a tax-exempt organization.[16] The hospital sublet building space to nonexempt persons. During 1973 and 1974, approximately six percent of the building was occupied by nonexempt subtenants. By the end of 1977, twenty-nine percent of the building's total leasable space had been leased to nonexempt subtenants.

The interest on an industrial development bond must be included as gross income for income tax purposes.[17] There are two tests used to determine if an obligation is an industrial development bond. To qualify for this status, both tests must be met. If the major portion of the proceeds of an obligation "are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person"[18] and if a major portion of the payment of principal and interest of an obligation is secured or derived from a property in a trade or business,[19] the obligation is an industrial development bond.

Since the obligations unquestionably met the second test,[20] the court of appeals looked to see if the requirements of the first test were present. Kirkpatrick contended that since Mercy Hospital was a tax-exempt entity, the criterion of the first test was not met. The Tenth Circuit noted that the intent of the law was to make sure that a tax-exempt entity, such as Mercy Hospital, would not become a conduit by which nonexempt persons would benefit from bond proceeds.[21] Therefore, the status of the subtenants was a determinative factor.

As the subtenants were nonexempt persons, the court looked to see if a "major portion" of the proceeds were used by these nonexempt persons in their trade or business. To make this determination, the court relied upon Treasury Regulation section 1.103-7(b)(3)(iii), which states that "the use of more than 25 percent of the proceeds of an issue of obligations in the trade or business of nonexempt persons will constitute the use of a major portion of such proceeds in such manner."[22]

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15. 605 F.2d 1160 (10th Cir. 1979).
16. I.R.C. § 501(c)(3) provides that hospitals may be exempt from taxation.
17. *Id.* § 103(b)(1).
18. *Id.* § 103(b)(2)(A).
19. *Id.* § 103(b)(2)(B).
20. 605 F.2d at 1162.
21. *Id.*
22. Treas. Reg. § 1.103-7(b)(3)(iii) (1972).

The taxpayer argued that since only six percent of the building was leased to nonexempt persons in 1973 and 1974, the test was not met for those years. The court concluded that as nonexempt subtenants occupied twenty-nine percent of the total leasable space in 1977, there was an indication that the original intent was to use the building for nonexempt persons.[23] Therefore, the bonds were declared to be industrial development bonds and the interest income thereon was deemed taxable.

III. IRS CIVIL SUMMONS

In *United States v. MacKay*,[24] the question before the Tenth Circuit was whether the IRS had abused its civil summons power.[25] In April of 1978, a criminal investigation of a Mr. and Mrs. Rodgers was initiated by the Criminal Investigation Division of the IRS, on the basis of information received from a county sheriff's office and from the Federal Bureau of Investigation. The Criminal Investigation Division, asserting that there was a possibility of unreported income, notified the Audit Division that the investigation should be conducted jointly.[26]

Denied access to the taxpayers' books and records, an IRS agent issued a summons to the First National Bank of Gillette, Wyoming, requesting the production of the Rodgers' bank records for 1975, 1976, and 1977. The IRS agent notified the taxpayers of the summons. As instructed by Mr. and Mrs. Rodgers, respondent Marshall MacKay, assistant vice president of the bank, refused to comply with the summons.[27] The IRS sought enforcement of the summons in district court. When the district court ordered compliance with the summons, respondent MacKay and Mr. and Mrs. Rodgers, as intervenors, appealed to the Tenth Circuit Court of Appeals.[28]

The respondent contended that the summons was invalid since the IRS had used its summons powers to pursue an investigation that was strictly criminal.[29] The Tenth Circuit held that the summons was enforceable as it was issued in good faith[30] prior to any recommendation to the Department of Justice that a criminal prosecution be undertaken, and because the civil tax determination had not been abandoned.[31]

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23. 605 F.2d at 1163. Taxability of the interest income is not to be determined yearly by the fluctuation in the amount of space rented to nonexempt persons.
24. 608 F.2d 830 (10th Cir. 1979).
25. I.R.C. § 7602.
26. 608 F.2d at 832.
27. *Id.* at 831.
28. *Id.*
29. The respondent also contended that the Right to Financial Privacy Act of 1978 barred the disclosure of the taxpayers' bank records. The court found this argument to be inapplicable in view of the legislative history and the express and implied provisions of the Act. *Id.* at 834.
30. In United States v. Powell, 379 U.S. 48 (1964), the Supreme Court held that the Commissioner need not show probable cause after the ordinary limitations period expired. Instead, a good faith standard was imposed. Good faith could be shown by establishing that the investigation was for a legitimate purpose, that the inquiry was relevant to the purpose, that the Commissioner did not already possess the information, and that the proper administrative steps required by the Code had been taken. The burden of showing abuse was placed on the taxpayer.
31. 608 F.2d at 833 (citing United States v. LaSalle National Bank, 437 U.S. 298 (1978)).

IV. Constructive Receipt

The constructive receipt of interest, which is taxable as income, was examined by the Tenth Circuit in *Estate of Shelton v. Commissioner*.[32] In 1970, the IRS refunded over $150,000[33] of improperly assessed taxes and interest to the Osage Indian Agency, on behalf of the Elkins estate.[34] Because Shelton, the sole residuary beneficiary of the Elkins estate, had died in 1967, the Indian Agency advised the co-executors of the Shelton estate that they had to obtain an additional co-executors' bond before the funds could be paid to them. The co-executors did not obtain the bond until 1974.

The Commissioner determined that the Shelton estate's gross income for 1970 should have included that part of the tax refund allocated to interest.[35] The Tax Court upheld the Commissioner's decision, but reduced the amount of the deficiency by twenty percent, the amount withheld by the Indian Agency to pay the legal fees arising from the litigation to obtain the original refund.[36]

In upholding the Tax Court, the court of appeals found that the agency had tendered payment to the Shelton estate in 1970,[37] and the requirement that the co-executors obtain an additional bond did not place "substantial limitations or restrictions" on the right to receive the income.[38] Therefore, the interest on the tax refund was constructively received by the estate, and taxable as income, in 1970.

V. Time for Assessment—Three Year Limit

Dowell v. Commissioner[39] involved taxpayers who had filed fraudulent tax returns for the years 1963 through 1966 and who, in 1968, filed nonfraudulent amended returns for those years. The government had used the amended returns in the investigation and prosecution of a fraud case against the taxpayers.[40] The IRS used the amended returns to make a determination of additional taxes, and to assess penalties and interest due. In late 1974, the IRS advised the taxpayers of deficiencies. The taxpayers petitioned the United States Tax Court, seeking a refund and a bar against any additional assessment of deficiencies.[41] The Tax Court upheld the Commissioner, and the taxpayers appealed to the Tenth Circuit Court of Appeals.

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32. 612 F.2d 1276 (10th Cir. 1980).
33. Over $92,000 was allocated to interest. *Id.* at 1278.
34. Mary Jacqueline Elkins was a noncompetent Osage Indian who died in 1932. *Id.*
35. *Id.*
36. Estate of Jacqueline E. Shelton, 68 T.C. 15 (1977).
37. The taxpayer had argued that the income should be taxed to the Elkins' estate. The court noted that I.R.C. § 661(a)(2) provides that an estate can properly deduct any amount paid or credited to a beneficiary and I.R.C. § 661(a)(2) provides that such amounts are taxable to the beneficiary. Therefore, even if included in the Elkins' estate, the interest income was taxable when constructively received by the Shelton estate. 612 F.2d at 1278-79.
38. 612 F.2d at 1279.
39. 614 F.2d 1263 (10th Cir. 1980).
40. *See* United States v. Dowell, 446 F.2d 145 (10th Cir. 1971) (affirming the convictions of defendants Alfonzo and Vivian Dowell for attempting to evade or defeat federal income taxes).
41. The Tax Court found that the nature of original returns determined the applicable statute of limitations. Since the original returns were fraudulent, the Commissioner could assess the tax at any time, according to I.R.C. § 6501(c)(1). The Tax Court found the three year

The taxpayers argued that the filing of the amended returns had started the statute of limitations[42] to run and that, under this accounting, the government had failed to make an assessment within the allotted three year period. The IRS responded with the argument that, because the original returns were fraudulent, the assessment against taxpayers could be made at any time.[43] The Tenth Circuit reasoned that as the amended filings satisfied the definition of a return,[44] the statute of limitations began to run in 1968.[45] Accordingly, the judgment of the Tax Court was reversed, and the case was remanded.[46]

The government also had contended that because the 1963 and 1964 amended returns were unsigned, the statute of limitations period never began to run.[47] The court concluded that the use of the amended returns in the fraud action constituted acceptance by the government, and commenced the running of the statute.[48]

VI. Two Year Limit on Refunds

Snyder v. United States[49] presented the question of whether a taxpayer is entitled to obtain a refund of gift taxes which were erroneously paid more than two years prior to filing of the refund claim. In May of 1973, the IRS made a jeopardy assessment[50] against the taxpayer. When no payments were forthcoming, the IRS began collecting the income from the taxpayer's rental properties. The assessment was not paid in full until March 1976. Three months later, the taxpayer filed a claim for refund of the full amount assessed and collected.[51] The IRS eventually conceded that the assessment was entirely unfounded, but the Commissioner refused to refund that portion of the assessment not paid within two years of the first claim for re-

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general statute of limitations provided in I.R.C. § 6501(a) to be inapplicable. Dowell v. Commissioner, 68 T.C. 646 (1977).

42. "Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed . . . ." I.R.C. § 6501(a).

43. "In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, . . . at any time." I.R.C. § 6501(c)(1).

44. "Perfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such . . . , and evinces an honest and genuine endeavor to satisfy the law. This is so though at the time of filing the omissions or inaccuracies are such as to make amendment necessary." 614 F.2d at 1265 (quoting Zellerbach Paper Co. v. Helvering, 293 U.S. 172, 180 (1934)).

45. I.R.C. § 6501(a). The court noted that the "at any time" provision of I.R.C. § 6501(c)(1) is necessary to give the government ample time to uncover information which the taxpayer fails to provide. But once the taxpayer provides the government with the necessary information, the three year statute takes over.

46. 614 F.2d at 1267.

47. *Id.* at 1266. *See* Kalb v. United States, 505 F.2d 506 (2d Cir. 1974); Doll v. Commissioner, 358 F.2d 713 (3d Cir. 1966).

48. 614 F.2d at 1267.

49. 616 F.2d 1187 (10th Cir. 1980).

50. If the Secretary believes that the assessment or collection of a deficiency, as defined in section 6211, will be jeopardized by delay, he shall, notwithstanding the provisions of section 6213(a), immediately assess such deficiency (together with all interest, additional amounts, and additions to the tax provided for by law), and notice and demand shall be made by the Secretary for the payment thereof.

I.R.C. § 6861(a).

51. 616 F.2d at 1187.

fund.[52] The taxpayer initiated a suit in district court contesting the IRS disallowance. The taxpayer was granted a summary judgment.[53] The IRS appealed to the Tenth Circuit Court of Appeals.

In reversing the decision of the district court,[54] the Tenth Circuit court relied on Internal Revenue Code section 6511(b)(2)(B) which states that "the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim." The court noted that this provision had been consistently interpreted to mean that the taxpayer's recovery was limited to the amounts paid within two years of bringing suit.[55] The court reasoned that any other construction would allow a taxpayer to extend the time for filing a claim by making small periodic payments.[56] The taxpayer asserted that a strict reading of the Code results in a hardship on a taxpayer who is unable to pay an assessment within two years. The court answered that an alternative remedy was available. A taxpayer may petition the United States Tax Court for a redetermination of the assessment prior to making any payment.[57]

VII. Penalty Under Section 6672 or 3505

In *Fidelity Bank v. United States*,[58] the Tenth Circuit Court of Appeals reversed the trial court for improperly instructing the jury that the government bore the risk of nonpersuasion in the action below. The case arose when a bank sought a refund of penalties assessed in accordance with section 6672 of the Internal Revenue Code.[59] In 1971, CDI Homes, Inc. (CDI) had obtained a one million dollar revolving credit line from Fidelity Bank, N.A. (Fidelity). By 1973, CDI had overdrawn its credit line and had ceased operations. Fidelity had agreed to permit CDI to overdraw its account, but Fidelity reserved the right to examine and approve each overdraft.

Checks clearly marked with the word "payroll" were among those approved by Fidelity in 1973. These payroll checks included gross wages, less income taxes and FICA taxes which had been withheld. CDI had no other source of funds and relied on Fidelity to honor checks for the amount of the

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52. The IRS relied on I.R.C. § 6511(a), which states that a

> claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid.

53. The district court held that the two year period of limitation of I.R.C. § 6511(a) did not begin to run until all of the assessment had been collected. 616 F.2d at 1188.

54. *Id.* at 1189-90.

55. *Id.* at 1188.

56. *Id.*

57. *Id. See also* I.R.C. § 6213.

58. 616 F.2d 1181 (10th Cir. 1980).

59. Section 6672(a) provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

I.R.C. § 6672(a).

withholdings.[60] On June 26, 1973, Fidelity dishonored CDI checks which had been presented through normal banking channels on June 25. The dishonored checks included one for the withholdings of the second quarter of 1973. In late June, the bank commenced the liquidation of the company. Fidelity used the proceeds of subsequent sales to pay wages and to reduce CDI's overdrawn account. Taxes were withheld from the wages, but the taxes were not paid to the IRS.[61]

The Commissioner assessed a one hundred percent penalty against Fidelity.[62] Although Fidelity paid a portion of the assessment,[63] the bank subsequently brought suit for refund. The Commissioner counterclaimed, demanding payment of the unpaid balance of the penalty and payment of the taxes due and owing. The IRS counterclaim was based upon section 3505(b) of the Code.[64] The trial court found for Fidelity, and the government appealed.

The Tenth Circuit Court of Appeals decided that each overdraft constituted a separate loan to CDI. The court asserted that since the checks were clearly marked "payroll," Fidelity must have known that it was providing funds for wages.[65] The court reasoned that Fidelity also must have known that CDI could not make a timely payment or deposit to cover the taxes. Furthermore, after CDI's closure, Fidelity controlled CDI's income.[66] The appellate court concluded that Fidelity was clearly liable for the unpaid tax under section 3505(b). The Tenth Circuit remanded the case for a determination of the exact amount of penalty to be imposed.[67] As to the government's original claim under section 6672, the Tenth Circuit court found that the jury properly could have concluded that Fidelity was not a responsible person.[68] Nevertheless, because the jury had been improperly told that the government bore the risk of nonpersuasion, the case was remanded on the section 6672 issue as well.[69]

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60. 616 F.2d at 1183.
61. *Id.* at 1184.
62. *Id.* at 1182.
63. Normally, the taxpayer must pay the full tax or penalty before bringing suit in district court. To challenge a penalty under I.R.C. § 6672, however, the taxpayer need pay only one employee's taxes.
64. Section 3505(b) provides: If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purposes of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

I.R.C. § 3505(b).

65. 616 F.2d at 1184.
66. *Id.*
67. *Id.* at 1185.
68. *Id.* at 1186.
69. *Id.*