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TAXATION

OVERVIEW

The Tenth Circuit considered a limited number of federal taxation cases this year. All of the cases addressed fairly routine issues and followed well-established legal precedents. However, an examination of the particular circumstances of the cases may clarify the interpretation of the law by the Tenth Circuit in the areas covered by these opinions.

I. BAD BUSINESS DEBTS

In *Harsha v. United States*,¹ an orthopedic surgeon had loaned and guaranteed money to a corporation whose sole purpose was to employ and rehabilitate a disabled patient. The court held that where such loans were made to improve the patient's psychological well-being and not in good faith anticipation of either advancing or preserving the profit motive expectations of the doctor's medical practice, the losses sustained were non-business bad debts. Non-business bad debts are deductible as short-term capital losses, but business bad debts are fully deductible against ordinary income.²

The key question on appeal was whether Harsha's losses were sufficiently related to his medical practice so as to be fully deductible as bad business debts, the proper standard of a "proximate" relation being whether the taxpayer's dominant motivation in making the loans was to benefit his trade or business.³ To constitute one's trade or business for internal revenue purposes, the activity must occupy a substantial amount of the taxpayer's time and be undertaken in good faith for profit.⁴

Because Harsha, by his own admissions, established that the loans and guarantees were made absent any expectation of preserving the profit-making activities of his medical practice, the Tenth Circuit affirmed the trial court in granting summary judgment for the government.⁵ The court indicated that the key inquiry in assessing the question of dominant motivation at the time loans or guarantees are made should revolve around the objective facts rather than the taxpayer's subjective intent, but where the subject intent is clearly not to benefit his trade or business, as was the case here, summary judgment against the taxpayer is proper.⁶

1. 590 F.2d 884 (10th Cir. 1979).

2. *Id.*

3. Section 166 of the Internal Revenue Code of 1954, 26 U.S.C. § 166(a), and the Treasury regulations interpreting it for application to individual taxpayers require that a taxpayer claiming a "business" bad debt establish that he is engaged in a trade or business and that the loss has a proximate relation to the conduct of that trade or business. 590 F.2d at 886.

4. 590 F.2d at 887 (citing *Imbesi v. C.I.R.*, 361 F.2d 640 (3d Cir. 1966)).

5. 590 F.2d at 887.

6. *Id.* at 886.

II. TRIAL BY JURY

*United States v. Anderson*⁷ involved the right to a trial by jury in tax cases. The controversy arose mainly over an increase in gain which the Internal Revenue Service (IRS) said should be recognized from Anderson's sale of a glass business to a corporation.⁸ Anderson refused and failed to pay the balance assessed at the district court level, arguing on appeal that it was reversible error: (1) to deny him the right to a jury under the Seventh Amendment; (2) to refuse to suppress evidence obtained by unlawful coercion, threats and intimidation by the government; and (3) to deny his request that the amount sued for be defined other than in dollars because the value of Federal Reserve notes is uncertain.⁹

The Tenth Circuit reversed and remanded the judgment. The government took the position that the defendant's demand for a jury trial was untimely insofar as it was filed more than ten days after his answer and counterclaim, which the government unsuccessfully argued were his "final pleadings."¹⁰ The court, refusing to consider the answer and counterclaim to be final pleadings, held the demand was timely insofar as, at the time of filing, questions about the sufficiency of the counterclaim alleging threats, coercion and intimidation remained, and insofar as the issues raised in the counterclaim were identical to those raised in the complaint.¹¹

Satisfied that the demand was timely, the court found furthermore that the trial court had acted correctly in deciding the issue on its merits rather than rejecting it as untimely.¹² On the merits, however, the Tenth Circuit disagreed with the trial court and determined that the nature of the issue comes within the seventh amendment and entitles the defendant to a jury trial. Of importance to the court were the following factors: (1) English common law established the right; (2) the remedy sought was for a personal judgment for taxes assessed; and (3) the factual issue of tax liability as presented was appropriate for jury resolution.¹³

The court did not address the coercion issue other than to acknowledge that the trial court found it to lack merit.¹⁴ It did reject arguments that the claim not be assessed in dollars as groundless.¹⁵

7. 584 F.2d 369 (10th Cir. 1978).

8. The IRS found a greater benefit to the defendant through the assumption of his indebtedness by the corporation than he stated, and also disagreed with his basis in some equipment and a building, among other things. *Id.* at 370.

9. *Id.*

10. FED. R. CIV. P. 38(b) provides:

Any party may demand a trial by jury of any issue triable of right by a jury by serving upon the other parties a demand therefor in writing at any time after the commencement of the action and not later than 10 days after the service of the last pleading directed to such issue.

11. 584 F.2d at 372-73.

12. *Id.* at 371.

13. *Id.* at 373-74 (citing *Ross v. Bernard*, 396 U.S. 531 (1970), and *Damsky v. Zavatt*, 289 F.2d 46 (2d Cir. 1961)).

14. 584 F.2d at 371-72.

15. The court took judicial notice of the fact that federal reserve notes are valued in dollars, citing both statutory and case law authority. *Id.* at 374.

III. VALIDITY OF SUBCHAPTER S ELECTION

In *Brutsche v. Commissioner*,¹⁶ the court considered the validity of a subchapter S election, which allows the shareholders of an electing corporation which qualifies to avoid the double taxation of a corporation.¹⁷ The taxpayers, who initially had argued that their election was valid, reversed their position by arguing that the election was invalid because the filing was untimely and lacked the necessary shareholders' consent.

A. *Timeliness*

In addressing the timeliness of the election, the court determined whether Treasury Form 2553 was filed within the first month of the corporation's taxable year. The corporation had shareholders on May 1, 1961, conducted business by May 26, 1961, and filed its election on June 26, 1961. Section 1372 provides that a subchapter S election must be made by a small business corporation during the first month of its taxable year or during the preceding month, and Treasury Regulations¹⁸ establish that the first month of the taxable year for a new corporation begins when the corporation has shareholders, acquires assets, or begins conducting business, whichever occurs first. Accordingly, the June 26 election was not within the first month and therefore not valid for that taxable year. It was, however, upon the finding of a July 1-June 30 fiscal accounting period, determined timely for the following fiscal year beginning in 1962 under section 441.¹⁹

B. *Consent*

Nonetheless, even if timely, the election was still invalid for the fiscal year ending June 30, 1962, if not accompanied by the requisite shareholders' consent. Since the original consent submitted had been returned as defective and incomplete by the IRS with the admonition that the election would be ineffective unless a subsequent proper consent was filed within twenty days, the issue became an evidentiary one.²⁰

Neither the Tax Court nor the Tenth Circuit found any direct evidence of a later properly filed shareholder consent. The court agreed that the Commissioner's position, that the election was not invalid for lack of the second consent statement, was presumptively correct because a copy of the letter extending the time for filing was in the taxpayers' records but the Tenth Circuit disagreed with the Tax Court that an inference of compliance necessarily flows therefrom.²¹ To prove the election invalid on the grounds asserted, taxpayers had the burden of showing that no consent was properly filed, which burden they met insofar as it is possible to prove a negative.

Explaining that the nonexistence of a document or the nonoccurrence of an event can only be shown by inference from circumstantial evidence,

16. 585 F.2d 436 (10th Cir. 1978).

17. I.R.C. §§ 1371-79.

18. Treas. Reg. § 1.1372-2(b)(1), T.D. 6500 (1960).

19. 585 F.2d at 439.

20. *Id.* at 440.

21. *Id.* at 441.

and since no verification of later consent could be found after the IRS diligently searched its records, the court held that the taxpayers met their evidentiary burden.²² The case was remanded and the deficiency judgments set aside.²³

IV. SECTION 38 CREDITS

*United Telecommunications, Inc. v. Commissioner*²⁴ addressed the issue of whether regulations governing investment tax credit validly precluded the taxpayer, a public utility, from taking a double tax credit. Under the applicable state and federal regulatory provisions,²⁵ the taxpayer had capitalized the depreciation on its construction equipment as part of the cost basis of the newly constructed property and then used that basis to compute the investment tax credit. An investment tax credit was also claimed on the cost of the same construction equipment when it qualified, resulting in essentially a double credit for the same expenditure, once for the equipment and again as the allocated cost of the constructed property.²⁶ Both the equipment and the constructed property were treated as section 38 property under the Internal Revenue Code and were thus eligible for an investment tax credit.²⁷

The issue arose from the fact that transportation and construction equipment have different useful lives and both qualify for section 38 property credit. The court precluded the taxpayer from attempting to maximize its investment tax credit by computing the credit in part on the equipment and in part on the property constructed, while it gave the taxpayer the benefit of the property's longer useful life.²⁸

The Tenth Circuit held that the purpose of the Treasury Regulations in question²⁹ was clearly to prevent just such a double tax credit as was here sought. Even though no specific statutory prohibition against it could be found, the presumption is that statutes and regulations preclude a double deduction.³⁰ To the extent, then, that the ambiguities in the regulations could be read to preclude the double credit, which was here reasonable and consistent with the statutory language, the court upheld the regulations.

V. BONUS AND DELAY RENTALS FOR RESTRICTED TRIBE MEMBER

*Clark v. United States*³¹ concerned oil and gas cash bonus and delay rental payments paid to a noncompetent, restricted member of the Five Civil-

22. *Id.* at 442.

23. *Id.* at 443.

24. 589 F.2d 1383 (10th Cir. 1978), *cert. denied*, 99 S. Ct. 2839 (1979).

25. *Id.* at 1384. The applicable federal provisions are 26 U.S.C. §§ 38, 46(c)(1), (c)(1)(A); 26 U.S.C.A. §§ 46(a)(1), (3) (West Supp. 1979).

26. 589 F.2d at 1384.

27. *Id.* at 1386.

28. The equipment was used to build facilities which qualified for investment tax credit as section 38 property. The property and equipment here had useful lives in excess of eight years at the time they were placed in service and were thus eligible for the maximum investment tax credit. *Id.*

29. Treas. Reg. §§ 1.46-3(c)(1), .48-1(b)(4).

30. 589 F.2d at 1387-88.

31. 587 F.2d 465 (10th Cir. 1978).

lized Tribes on restricted, allotted Indian land. The issue was whether such payments, when followed by oil production, were subject to federal income tax as advance royalty. Clark, a Chickasaw Indian, had been allotted one hundred sixty acres of land designated tax exempt for her life provided title remained in her.³² During the period of her restricted status, an oil and gas lease agreement had been made with respect to a portion of her homestead and approved by the Bureau of Indian Affairs in its capacity as her personal guardian and trustee of her land and income.³³

The IRS contended that cash bonus and delay rental payments made at the time of leasing a tract for oil and gas are taxed as ordinary income³⁴ and furthermore, when cost depletion is used, a distinction is made between those situations where there is later commercial production and those where there is not.³⁵ The IRS took the position that these general rules should apply in the instant case. However, the Tenth Circuit affirmed the district court in granting summary judgment for Clark.

The court, affirming its decision in *United States v. Daney*,³⁶ held that these payments to a noncompetent, restricted Chickasaw on restricted, allotted Indian land were not taxable as advance royalty even though oil production followed. The fact that production was later obtained from this lease, which might not have been the case in *Daney*, was seen as a distinction without a difference,³⁷ and the plaintiff was allowed to recover the wrongfully paid taxes plus interest.³⁸

The key question became whether or not a 1928 act³⁹ clearly removed the tax exemption given the tribes with respect to this land⁴⁰ when applied to cash bonus and delay rental payments made for oil and gas leases.

The court conceded that the intent of the act could be read to support either conclusion, but decided that the legislative history and public policy mandated a construction of these acts to favor the Indians. Citing the fact

32. Act of Aug. 11, 1955, ch. 408, § 1, 69 Stat. 666.

33. 587 F.2d at 466.

34. See *Burnet v. Harmel*, 287 U.S. 103 (1932).

35. See *Treas. Reg. § 1.612-3(a)* (1960).

36. 370 F.2d 791 (10th Cir. 1966).

37. 587 F.2d at 468.

38. The court mentioned briefly that arguably the government breached its duty to Mrs. Clark insofar as it did not seek a refund of these taxes shortly after the decision in *United States v. Daney*, 370 F.2d 791 (10th Cir. 1966). 587 F.2d at 469.

39. Section 3 of the Act of May 10, 1928, ch. 517, 45 Stat. 495 is worded as follows:

That all minerals, including oil and gas, *produced* on or after April 26, 1931, from restricted allotted lands of members of the Five Civilized Tribes in Oklahoma, or from inherited restricted lands of full-blood Indian heirs or devisees of such lands, shall be subject to all State and Federal taxes of every kind and character the same as those *produced* from lands owned by other citizens of the State of Oklahoma; and the Secretary of the Interior is hereby authorized and directed to cause to be paid, from individual Indian funds held under his supervision and control and belonging to the Indian owners of the lands, the tax or taxes so assessed against the royalty interest of the respective Indian owners in such oil, gas, and other mineral *production*. (Emphasis supplied).

The legislative history indicated nothing related to federal taxes, but rather a concern solely with the Oklahoma Gross Production Tax. 587 F.2d at 468.

40. Act of June 28, 1898, ch. 517, § 29, 30 Stat. 495; Act of April 26, 1906, ch. 1876, § 19, 34 Stat. 137.

that Native American Indians have consistently received different tax treatment than other citizens, especially with respect to restricted lands, the court concluded that absent clear and unambiguous inclusion in a taxation scheme, ambiguities should be resolved in the Indians' favor.⁴¹

VI. FIFTH AND SIXTH AMENDMENT ARGUMENTS

In *United States v. Brown*,⁴² the defendant taxpayer was convicted of willful failure to file his individual income tax return. Brown had filed returns which disclosed no information from which his federal income tax liability could be computed, inserting words such as "unknown" or "Fifth Amendment" in the blanks provided for dollar amounts.⁴³ Taking the position that filing a return containing no information is tantamount to filing no return at all, the court rejected the defendant's arguments that he could not be convicted of failure to file a return when he did file a return.⁴⁴

The court rejected Brown's attempts to employ the fifth amendment privilege against self-incrimination as a defense. While the fifth amendment can be invoked to protect one from revealing an illegal source of income, it does not protect one from disclosing the amount of such income on a tax return.⁴⁵

As to the defendant's contention that he had been denied a speedy trial under the sixth amendment and the Speedy Trial Act,⁴⁶ the court articulated several factors of inquiry. First, where the information was filed against a defendant before July 1, 1976, as in this case, the Speedy Trial Act did not apply.⁴⁷ Secondly, despite the fact that thirteen months had elapsed between the filing of the information against Brown and the trial, the court was reluctant to find a speedy trial deprivation absent any prejudice to the defendant. Since the delay was due to the judge's illness and overcrowded dockets, the delay had not been sought by the government to prejudice the defendant, and since the defendant had not demanded a speedy trial or established that the delay prejudiced him, the Tenth Circuit found no violation of Brown's constitutional rights.⁴⁸

Brown further asserted unsuccessfully that evidence obtained from third parties through IRS summons should be suppressed. The IRS had issued a summons to Brown's bank to produce records material to his tax liability. The court upheld the issuance of such summons even where an investigation

41. 587 F.2d at 467-68.

42. 600 F.2d 248 (10th Cir. 1979).

43. *Id.* at 251.

44. *Id.* at 252.

45. *Id.* (citing *Garner v. United States*, 424 U.S. 648 (1976), and *United States v. Sullivan*, 274 U.S. 259 (1927)).

46. 18 U.S.C. § 3161(c) (1976).

47. 600 F.2d at 253 (citing 18 U.S.C. § 3163(b) (1976); *United States v. Grismore*, 564 F.2d 929, 932 (10th Cir. 1977), *cert. denied*, 435 U.S. 954 (1978)).

48. 600 F.2d at 253-54. The Supreme Court, in *Barker v. Wingo*, 407 U.S. 514 (1972), invoked a balancing test with respect to the type of constitutional violation alleged here. In weighing the circumstances, the Court considered four factors, not necessarily an exclusive list: the length of the delay, the reason therefor, timely assertion by the defendant of the right, and prejudice to the defendant.

pursuing both civil and possible criminal consequences exists, explaining that such summons can be used to aid an investigation which is seeking to determine whether criminal conduct has occurred, but such summons must be issued in good faith and prior to the recommendation to the Justice Department for criminal prosecution.⁴⁹ No constitutional violations were found insofar as bank records are neither owned nor possessed by the taxpayer, because the incriminating evidence of third parties is not tantamount to testifying against oneself, and because no valid expectation of privacy exists in bank records.⁵⁰

Brown also alleged a violation of his sixth amendment right to the assistance of counsel, but the court found the argument to be merely an excuse and delay tactic. Explaining that the sixth amendment does not contemplate lay representation, rather it anticipates representation by a person authorized to practice law, the court looked to the facts: Brown had failed repeatedly to get a lawyer with over a year to do so; in addition, appointment of counsel by the court just prior to the trial, and the fact that the court had allowed Brown to represent himself were considered procedurally sufficient, especially since the record failed to establish any mockery of justice or ineffectiveness of representation.⁵¹

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49. 600 F.2d at 255 (citing *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 307 (1978); *Donaldson v. United States*, 400 U.S. 517, 521, 533, 536 (1971); *United States v. Billingsley*, 469 F.2d 1208, 1209 (10th Cir. 1972); I.R.C. § 7602, as amended in 1976.

50. 600 F.2d at 256. See generally *Mills, The Fifth Amendment Privilege and Other Protections Against Self-Incrimination in Federal Tax Investigations*, 43 MO. L. REV. 677 (1978); 1 FLA. ST. U. L. REV. 506 (1973).

51. 600 F.2d at 256-58.

