Federal Taxation

by Michael H. Plowgian*
Svetoslav S. Minkov**
and T. Wesley Brinkley***

I. INTRODUCTION

The courts in the Eleventh Circuit were involved in a number of relatively prominent tax related cases in 2005. Two cases that were previously highlighted in this publication were overturned on appeal.[1] The United States Supreme Court reversed and remanded the Eleventh Circuit in the tax procedure case of *Ballard v. Commissioner*.[2] In addition, the Eleventh Circuit reversed the United States District Court for the Southern District of Florida in *American Bankers Insurance Group, Inc. v. United States*,[3] holding that the federal telecommunications excise tax did not apply to telecommunications services for which the charge varied by time, but not by distance.[4] The Eleventh Circuit also partially affirmed and partially reversed the Tax Court in *Estate of Blount v. Commissioner*,[5] holding that a decedent's stock in a company had to be valued for estate tax purposes at fair market value, but that

---

* Associate in the firm of King & Spalding LLP, Atlanta, Georgia. Denison University (B.A., 1999); Tufts University (M.A.L.D., 2003); Harvard University (J.D., 2003).

** Associate in the firm of King & Spalding LLP, Atlanta, Georgia. University of Illinois (L.L.M., 2001); University of Illinois (J.D., 2004); University of Illinois (J.S.D., 2004); Sofia University (Bulgarian J.D. equivalent).

*** Associate in the firm of King & Spalding LLP, Atlanta, Georgia. University of North Carolina (B.A., 2002); Harvard University (J.D., 2005).

This Article does not represent the views of King & Spalding LLP, but solely reflects the views of its authors.

1. *See* Donald R. Bly & Michael H. Plowgian, *Federal Taxation*, 55 MERCER L. REV. 1313 (2004); Michael H. Plowgian & Svetoslav S. Minkov, *Federal Taxation*, 56 MERCER L. REV. 1287 (2005).

2. 125 S. Ct. 1270 (2005).

3. 408 F.3d 1328 (11th Cir. 2005).

4. *Id*. at 1330.

5. 428 F.3d 1338 (11th Cir. 2005).

insurance proceeds the company received from an insurance policy on the decedent's life should not be considered when determining the fair market value of the stock.[6] Finally, the United States District Court for the Southern District of Florida held that medical residents employed by a teaching hospital did not qualify for the student exemption from social security taxes.[7]

II. SUPREME COURT CASE—ORIGINAL SPECIAL TRIAL JUDGE REPORT MUST BE INCLUDED IN TAX COURT RECORD

In *Ballard v. Commissioner*,[8] the Supreme Court ruled that Rule 183 of the Tax Court Rules of Practice and Procedure ("Rule 183")[9] requires the Tax Court to include the original special trial judge's report in the appellate record when the Tax Court appoints a special trial judge to hear the case.[10]

The underlying case in *Ballard* concerned a scheme of alleged kickbacks to Claude Ballard, which he failed to report as income on his income tax returns. The Internal Revenue Service (the "Service") sent Ballard notices of deficiency alleging that he owed additional taxes, and subsequently alleged that Ballard's tax returns were fraudulent. Ballard filed a petition for redetermination of the deficiencies in the Tax Court.[11] The Tax Court chief judge assigned the case to Special Trial Judge D. Irvin Couvillion for trial. Under the rules governing the Tax Court, if the amount of taxes at issue exceeds $50,000, as it did in *Ballard*, a special trial judge may be assigned to preside over the trial and issue a report containing recommended fact findings and conclusions as to the taxpayer's liability, though the final decision rests with the Tax Court.[12]

On or before September 2, 1998, Judge Couvillion submitted to the chief judge a report containing his findings of fact and opinion. On September 2, 1998, the chief judge assigned the case to Tax Court Judge Howard A. Dawson, Jr., for review of the special trial judge's report.[13] Judge Dawson's decision purported to have adopted the findings contained in the report submitted by Special Trial Judge Couvillion, and consisted entirely of a document labeled "Opinion of the Special Trial

---

6. *Id*. at 1340.
7. *United States v. Mount Sinai Med. Ctr.*, 353 F. Supp. 2d 1217 (S.D. Fla. 2005).
8. 125 S. Ct. 1270 (2005).
9. 26 U.S.C. App. (2000).
10. 125 S. Ct. 1270, 1283.
11. *Id*. at 1276.
12. *Id*. at 1277.
13. *Id*.

Judge."[14] That decision held that Ballard and his codefendants had acted with intent to deceive the government, and held them liable for underpaid taxes and substantial fraud penalties.[15]

Due to conversations that Randall Dick, the attorney for Burton Kanter (one of Ballard's copetitioners), claimed to have had with two other Tax Court judges, Ballard and his copetitioners came to believe that the document set forth in Judge Dawson's opinion was not the report submitted by Special Trial Judge Couvillion. According to Dick, the two Tax Court judges told him that Special Trial Judge Couvillion's original report concluded that the petitioners did not owe taxes with respect to certain payments and that the fraud penalty was not applicable. Moreover, Dick attested that the judges told him that Judge Dawson made changes to Special Trial Judge Couvillion's findings relating to credibility and fraud.[16]

The petitioners filed motions with the Tax Court seeking access to the original report of Special Trial Judge Couvillion. In response, the Tax Court, in a statement signed by the Tax Court chief judge, Judge Dawson, and Special Trial Judge Couvillion, maintained that Judge Dawson adopted the findings of fact and opinion of Special Trial Judge Couvillion. Further, the statement declared that to the extent that the petitioners sought any "preliminary drafts" of the special trial judge's report, such documents were not subject to production "because they relate to the internal deliberative processes of the Court."[17]

Ballard appealed the Tax Court's decision to the Eleventh Circuit, arguing that failure to produce the special trial judge's report constituted a denial of due process.[18] The Eleventh Circuit rejected that argument, concluding that the Tax Court's final decision was, in fact, Special Trial Judge Couvillion's report.[19] Moreover, the Eleventh Circuit determined that although the final report may have differed from the original draft after internal deliberations, that fact did not raise due process concerns.[20]

The Supreme Court granted certiorari and reversed the Eleventh Circuit.[21] Justice Ginsburg, writing for the majority, based the ruling on the language of Rule 183.[22] Rule 183(b) provides that, after trial,

---

14. *Id*.
15. *Id*.
16. *Id*. at 1277-78.
17. *Id*. at 1278.
18. *Id*.
19. Ballard v. Comm'r, 321 F.3d 1037, 1042 (11th Cir. 2003).
20. *Id*. at 1043.
21. *Ballard*, 125 S. Ct. at 1279.
22. *Id*.

the special trial judge "shall submit a report, including findings of fact and opinion, to the Chief Judge, and the Chief Judge will assign the case to a Judge . . . of the Court."[23] Rule 183(c) provides that the Tax Court judge to whom the case is assigned:

> may adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions. Due regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the findings of fact recommended by the Special Trial Judge shall be presumed to be correct.[24]

The Supreme Court reasoned that Judge Dawson did not take any action authorized by Rule 183(c) to supplement the record.[25] Thus, Judge Dawson's review could only have been predicated on Special Trial Judge Couvillion's original report, the trial transcript, and the other documents on file. Therefore, Judge Dawson, under Rule 183(c), should have given deference to the findings of Special Trial Judge Couvillion.[26] Instead, based on the affidavit by Dick and oral arguments before the Court, the majority concluded that Judge Dawson had treated Special Trial Judge Couvillion's report as an "in-house draft to be worked over collaboratively by the regular judge and the special trial judge."[27]

This process, the majority concluded, was not authorized by Rule 183.[28] Rule 183, according to the majority, refers to only one report of the special trial judge, and as described in Rule 183(b), requires the special trial judge to submit this report to the chief judge before the case has been assigned to a regular Tax Court judge.[29] The "Special Trial Judge's report" referred to in Rule 183(c), the findings of which are presumed to be correct, therefore must be the original report of the special trial judge described in Rule 183(b), not some subsequent report created by collaboration between the special trial judge and the Tax Court judge to which the case has been assigned.[30] To further support the position that the special trial judge's report referred to in Rule 183(c) is the original report, rather than the collaborative report, the majority stated that it would be difficult to understand how a Tax Court judge

---

23. *Id*. (citing 26 U.S.C. App. (2000)).
24. *Id*. (citing 26 U.S.C. App.).
25. *Id*.
26. *Id*. at 1279-80.
27. *Id*. at 1281.
28. *Id*. at 1282.
29. *Id*.
30. *Id*.

could give "due regard" to and "presum[e] to be correct," an opinion the judge collaborated in producing.[31] Moreover, the majority reasoned that the Tax Court's practice of not disclosing the special trial judge's original report impedes fully informed appellate review of the Tax Court's decision, and therefore, the report must be included in the appellate record.[32] Basing its decision on the Tax Court's own rules, the majority did not address the taxpayers' due process and other arguments.[33]

Justice Kennedy, joined by Justice Scalia, concurred in the opinion.[34] Chief Justice Rehnquist, joined by Justice Thomas, dissented from the opinion.[35] Justice Rehnquist's dissent essentially agreed with the reasoning of the Eleventh Circuit, stating that Special Trial Judge Couvillion's signature on the Tax Court's final decision presumptively establishes that any differences that might exist between the original report and the final opinion are the result of legitimate re-evaluation of the case.[36] The signature makes the report attributable to the special trial judge, and the Tax Court's interpretation of its own rules as not requiring the disclosure of initial drafts is not unreasonable.[37]

In response to the Supreme Court's decision, the Tax Court amended its rules, which now require the original special trial judge's report to be disclosed.[38]

On remand, the Eleventh Circuit obtained the original report of the special trial judge, which found that Ballard was not liable for the tax deficiencies asserted against him, concluded that there were no kickback schemes, and held that the government's allegations of fraud did not rise even to the level of "suspicion of fraud."[39] The Eleventh Circuit remanded the case to the Tax Court, ordering that: (1) the collaborative report and opinion of the Tax Court be stricken; (2) the original report of the special trial judge be reinstated; (3) the chief judge of the Tax Court assign the matter to a regular Tax Court judge who had no involvement in the preparation of the collaborative report; (4) the Tax Court review the matter in accordance with the dictates of the Supreme

---

31. *Id*. A Tax Court judge could, of course, give "due regard" to a collaborative report, although the majority appears to be arguing that the "due regard" standard is more sensibly applied to the original special trial judge's report.
32. *Id*. at 1283.
33. *Id*. at 1285.
34. *Id*. at 1286 (Kennedy & Scalia, JJ., concurring).
35. *Id*. at 1287 (Rehnquist, C.J. & Thomas, J., dissenting).
36. *Id*. at 1288 (Rehnquist, C.J. & Thomas, J., dissenting).
37. *Id*. at 1289 (Rehnquist, C.J. & Thomas, J., dissenting).
38. Ballard v. Comm'r, 429 F.3d 1026, 1030 (11th Cir. 2005).
39. *Id*. at 1029.

Court and give "due regard" to the credibility of the determinations of the special trial judge and presume the special trial judge's fact finding correct unless manifestly unreasonable.[40] The Eleventh Circuit also stated that any unexplained modifications of the special trial judge's report would be "unacceptable."[41] Given that all of the primary witnesses in the case are now deceased, it seems unlikely that Special Trial Judge Couvillion's findings will be overturned in the Tax Court on remand.[42]

III. ELEVENTH CIRCUIT CASES

A. Application of the Communications Excise Tax to Long-Distance Telephone Service

In *American Bankers Insurance Group, Inc. v. United States*,[43] the Eleventh Circuit reversed a lower court decision that had held that the federal excise tax on long-distance telephone service applies to charges that vary based only on the time of the call, rather than varying based on both the time and distance of the call.[44] In reversing the decision of the United States District Court for the Southern District of Florida, the Eleventh Circuit held that section 4252(b)(1)[45] of the Internal Revenue Code of 1986, as amended, (the "Code") unambiguously requires the toll charge to vary based on both time and distance.[46]

During the period from October 1, 1998 until March 31, 2002, American Bankers Insurance Group ("ABIG") purchased interstate, international, and intrastate long-distance service from AT&T. ABIG paid a uniform toll rate for interstate calls, uniform toll rates for intrastate calls, and toll rates for international calls that varied only according to which country the calls were being placed. AT&T collected the federal excise tax under section 4251 of the Code on all of these telephone services and remitted the tax to the Service. Subsequently, ABIG filed claims with the Service for a refund of $288,496.10 for the federal excise taxes paid from October 1, 1998 through September 30, 2001, and then filed an additional claim for refund of the federal excise

40. *Id*. at 1027, 1032.
41. *Id*. at 1031.
42. *Id*. at 1032.
43. 408 F.3d 1328 (11th Cir. 2005).
44. *See* Am. Bankers Ins. Group v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004). The district court decision is discussed in greater detail in Plowgian & Minkov, *supra* note 1, at 1294.
45. I.R.C. § 4252(b)(1) (2000).
46. *Am. Bankers*, 408 F.3d at 1332.

taxes paid from October 1, 2001 through March 31, 2002. The Service did not respond to the claims, and ABIG filed suit.[47]

Section 4251(a) of the Code imposes a three percent federal excise tax on "communications services."[48] Section 4251(b)(1) defines "communications services" to include "local telephone service," "toll telephone service," and "teletypewriter exchange service."[49] The district court focused on whether the long-distance services AT&T provided to ABIG qualified as "toll telephone service."[50] Section 4252(b) defines toll telephone service as:

> (1) a telephonic quality communication for which (A) there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication and (B) the charge is paid within the United States, and
> (2) a service which entitles the subscriber, upon payment of a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), to the privilege of an unlimited number of telephonic communications to or from all or a substantial portion of the persons having telephone or radio telephone stations in a specified area which is outside the local telephone system area in which the station provided with this service is located.[51]

The district court, ruling in the government's favor, found that the word "and" in the phrase "varies in amount with the distance *and* elapsed transmission time" in section 4252(b)(1) is unclear, and should be read to mean "or."[52] Thus, the district court endorsed a disjunctive, rather than a conjunctive, interpretation of the requirement that the tolls vary according to time and distance.

In its reversal of the district court, the Eleventh Circuit rejected the district court's finding of any ambiguity, stating, "Here, there is nothing in the statutory context to suggest that 'and' is used in the provision as meaning 'or.' The phrase is unambiguous. The plain meaning is clear: 'and' is used conjunctively."[53]

In its opinion, the district court wrote that even if the statutory language were unambiguous, "this is one of the rare cases where the legislative intent is sufficiently clear that . . . the [c]ourt would still be

47. *Id.* at 1330-31.
48. I.R.C. § 4251(a) (2000).
49. I.R.C. § 4251(b)(1) (2000).
50. *Am. Bankers*, 308 F. Supp. 2d at 1363.
51. I.R.C. § 4252(b).
52. *Am. Bankers*, 308 F. Supp. 2d at 1366.
53. *Am. Bankers*, 408 F.3d at 1332.

entitled to rely on extrinsic evidence of Congressional intent."[54] The Eleventh Circuit disagreed, declaring that "[w]here the statutory text is unambiguous the inquiry ends."[55]

Despite its statement regarding the irrelevance of the congressional intent in the face of clear statutory meaning, the Eleventh Circuit nonetheless noted that the legislative history supported its conclusion, rather than the district court's decision.[56] As described in the opinion, in 1965 Congress amended the definition of toll telephone service to comport with the type of service provided by AT&T, which at the time enjoyed a monopoly on all long-distance service.[57] When Congress passed the amendment, AT&T's long-distance service calculated its toll "on the basis of the elapsed time of each individual call, multiplied by a rate determined through the use of distance mileage bands . . . ."[58] Seen in this light, the conjunctive use of "and" in section 4252(b)(1) of the Code made perfect sense, because AT&T utilized rates that varied by both time and distance.

Furthermore, the Eleventh Circuit's decision referenced a number of other federal courts that had reached similar results: "Based on the foregoing, we agree with the numerous courts that have concluded the language in the phrase at issue is clear and unambiguous."[59] Last year in this publication, we discussed in detail the opinion of the district court and noted such countervailing authority, suggesting that the district court's decision in this case was questionable.[60]

The Eleventh Circuit also rejected the government's argument that the court should attribute "great weight" to Revenue Ruling 79-404,[61] which interpreted the statutory language of section 4252(b)(1) to apply to long-distance service for which the toll varied only according to time, and not distance: "The government argues that the court should give Revenue Ruling 79-404 *Chevron* deference. Under *Chevron*, the court must first determine whether the congressional intent is clear. If the intent is clear, the inquiry ends; the court and agency 'must give effect to the

---

54. *Am. Bankers*, 308 F. Supp. 2d at 1367 n.7.

55. *Am. Bankers*, 408 F.3d at 1333 (citing BedRoc Ltd., LLC v. United States, 541 U.S. 176, 183 (2004)).

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.* (citing, *e.g.*, Am. Online, Inc. v. United States, 64 Fed. Cl. 571, 577-78 (2005) ("Section 4252(b)(1) unambiguously requires that a toll charge vary in amount according to both the distance and duration of calls."); Honeywell Int'l, Inc. v. United States, 64 Fed. Cl. 188, 199 (2005) (finding section 4252 use of "and" to be conjunctive)).

60. *See* Plowgian & Minkov, *supra* note 1, at 1297-98.

61. Rev. Rul. 79-404, 1979-2 C.B. 382 (1979).

unambiguously expressed intent of Congress.'"[62] Echoing its previous statements concerning the lack of ambiguity in the statute, the Eleventh Circuit concluded that because section 4251(b)(1) of the Code "is clear and directly answers the question here, the inquiry ends; we need not give deference to Revenue Ruling 79-404."[63]

Similarly, the Eleventh Circuit rejected the government's argument that Congress had approved of the interpretation in Revenue Ruling 79-404 under the re-enactment doctrine.[64] Specifically, the government argued that, because Congress had amended and re-enacted the relevant statute since the promulgation of Revenue Ruling 79-404, Congress should be deemed to have approved of the interpretation in Revenue Ruling 79-404.[65] The Eleventh Circuit disagreed, noting that the re-enactment doctrine applies only where the agency's interpretation has been brought to the attention of Congress.[66] Nothing in the legislative history indicates that Congress was aware of Revenue Ruling 79-404, and therefore, the re-enactment doctrine does not apply.[67]

The Eleventh Circuit's decision in this case is consistent with decisions of other federal courts that have considered how the word "and" should be interpreted in this context, and subsequent decisions by other circuit courts have followed the Eleventh Circuit on this issue.[68] One can certainly argue that, as a policy matter, all telecommunications services should be subject to the same excise tax, regardless of the billing method for the service. Stretching the language of section 4252(b)(1) of the Code beyond its clear meaning, however, may not be the most appropriate way to achieve this result. If the statutory language, which defines toll telephone service by reference to AT&T's rate structure as it existed over forty years ago, does not adequately address the current telecommunications landscape, then the proper way to remedy such a deficiency is for Congress to amend the statute to reflect changed conditions in the provision of telecommunications services, and not for courts to guess what Congress's policy choice would be. Until the statute is amended,

---

62. *Am. Bankers*, 408 F.3d at 1335 (citing Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 843-44 (1984)).

63. *Id.*

64. *Id*.

65. *Id*.

66. *Id*. (citing North Haven Bd. of Educ. v. Bell, 456 U.S. 512, 535 (1982)).

67. *Id.*

68. *See* Nat'l R.R. Passenger Corp. (Amtrak) v. United States, 431 F.3d 374 (D.C. Cir. 2005); OfficeMax, Inc. v. United States, 428 F.3d 583 (6th Cir. 2005), *rehearing en banc denied*, No. 04-4009, 2006 U.S. App. LEXIS 8294 (6th Cir. 2005); Fortis, Inc. v. United States, No. 05-CF-2518, 2006 U.S. App. LEXIS 10749 (2d Cir. Apr. 27, 2006) (per curiam); Reese Bros., Inc. v. United States, No. 05-2135 (3d Cir. May 9, 2006).

the Eleventh Circuit's decision that Congress meant what it said when it tailored the definition of toll telephone service to include both time and distance requirements seems reasonable.[69]

B. The Value of Decedent's Shares, for Estate Tax Purposes, Should Not Include the Proceeds From the Company's Insurance on Decedent's Life if Used for the Redemption of Decedent's Shares

In *Estate of Blount v. Commissioner*,[70] the Eleventh Circuit partially affirmed and partially reversed the Tax Court's decision[71] that, for estate tax purposes, a decedent's stock had to be valued at fair market value, which included proceeds received by the company on the insurance policy it owned on the decedent's life, rather than at a lesser amount determined under a stock purchase agreement.[72] The Eleventh Circuit held that the decedent's stock had to be valued for estate tax purposes at fair market value, but the proceeds from the company's insurance on the decedent's life should not be considered when determining the fair market value of the stock.[73]

Blount Construction Company ("BCC") was a closely held Georgia corporation, whose sole shareholders were William Blount ("Blount") and James Jennings ("Jennings"). In 1981 BCC, Blount, and Jennings entered into a stock purchase agreement (the "1981 Agreement") under the terms of which, upon Blount's or Jennings's death, BCC would purchase the deceased's stock at a price agreed upon by the parties at that time, or if such price was not agreed upon, at a price based on the book value of the corporation. In the early 1990s, BCC purchased insurance policies on the lives of its shareholders to ensure that BCC's business could continue uninterrupted even if any of its shareholders died and BCC needed to redeem their shares pursuant to the 1981 Agreement. In 1992 BCC began an employee stock ownership program, which caused Jennings and Blount to cease being the sole owners of BCC.[74]

Jennings died in January 1996, and pursuant to the 1981 Agreement, BCC purchased his outstanding shares of BCC stock for about $3

---

69. On May 25, 2006, the Service issued Notice 2006-50, 2006-25 I.R.B. __ (June 19, 2006), stating that it will no longer collect the excise tax on long-distance telephone service, and that taxpayers will be able to file for refunds of the amounts they have paid that were billed to them after February 28, 2003.

70. 428 F.3d 1338 (11th Cir. 2005).

71. Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303 (2004).

72. *Estate of Blount*, 428 F.3d at 1340.

73. *Id*. at 1346.

74. *Id*. at 1340.

million, while simultaneously receiving a like amount in insurance proceeds. In October of 1996, Blount was diagnosed with cancer, and concerned about BCC's liquidity upon his death, he executed an amendment to the 1981 Agreement that bound his estate to exchange his shares in BCC for $4 million (the "1996 Amendment").[75] The 1996 Amendment did not provide for a future price adjustment to the $4 million purchase price, and it eliminated BCC's right under the 1981 Agreement to pay its obligation in installments.[76] Both the 1981 Agreement and the 1996 Amendment were subject to amendment with the parties' consent.[77] At the time of the 1996 Amendment, the book value of BCC's assets was approximately $8 million, suggesting that Blount's share of the book value of such assets was approximately $6.7 million.[78] Blount died in September 1997, and pursuant to the 1996 Amendment, BCC purchased his shares of BCC (which constituted approximately eighty-three percent of the outstanding shares of BCC) for $4 million. Upon Blount's death, BCC received approximately $3.1 million in insurance proceeds.[79]

Blount's estate filed a return declaring $4 million as the value of Blount's shares in BCC, and the Service filed a notice of deficiency, claiming that the fair market value of the shares was approximately $8 million.[80] In the Tax Court proceedings, an expert for the taxpayer testified that using solely an income-based approach for evaluation of the fair market value of Blount's shares—the $4 million value fixed in the 1996 Amendment—was "comparable" to the general practice of unrelated parties.[81] In addition, experts for the taxpayer and the government also testified to the fair market value of the shares using an income-based and an asset-based approach.[82] Using these approaches, the Tax Court found that BCC's value was $6.75 million, not including the $3.1 million insurance proceeds.[83] After adding the insurance proceeds to

75. *Id*.
76. *Id*. at 1341.
77. *Id*. at 1340, 1344.
78. *Id*. at 1341 n.2.
79. *Id*. at 1341-42.
80. *Id*. at 1341.
81. *Id*.
82. *Id*.
83. *Id*. at 1342. The taxpayer's expert found that the fair market value of BCC's stock was $6 million, but the Tax Court found that the taxpayer's expert improperly excluded $750,000 from such estimate. *Id*. at 1341-42. Similarly, the government's expert found that the fair market value of BCC's stock was $7 million, but the Tax Court found that the government's expert overvalued BCC's cash reserves by $250,000, and thus concluded that both experts essentially testified that BCC's value is $6.75 million. *Id*.

the $6.75 million value of BCC's stock, the Tax Court held that the fair market value of Blount's shares was approximately $8 million (eighty-three percent of $9.85 million).[84]

Section 2031(a) of the Code provides that a taxable estate generally includes all property of the decedent at its fair market value.[85] Property subject to a valid buy-sell agreement, however, can be included in the estate at a value different from its fair market value if, among other things, the buy-sell agreement was binding on the parties during the life of the decedent.[86] For agreements created or substantially modified after October 1990, the buy-sell agreement must also be comparable to similar arrangements negotiated at arm's length.[87]

The Eleventh Circuit affirmed the Tax Court's holding that the 1981 Agreement was substantially modified by the 1996 Amendment and, therefore, was subject to the post-1990 "comparability" requirement.[88] The Eleventh Circuit noted that the 1996 Amendment explicitly substituted the book value formula of the 1981 Agreement with a fixed value of $4 million for Blount's stock, and took away BCC's ability to pay the buyout price in installments.[89] Because such amendments were not a "*de minimis* change to the quality, value, or timing of the rights" of the parties, the Eleventh Circuit held that the 1996 Amendment was a substantial modification of the 1981 Agreement.[90]

The Eleventh Circuit also affirmed the Tax Court's holding that the 1981 Agreement, as modified by the 1996 Amendment (the "1996 Agreement"), did not qualify for the exception to the general rule that stock be valued at its fair market value.[91] This result was reached because the Eleventh Circuit concluded that the 1996 Agreement was not binding on Blount during his life.[92] The 1996 Agreement stated that it could be modified by the "parties thereto," and Blount and BCC were the only parties to the agreement.[93] Given that Blount was an eighty-three percent shareholder of BCC, its president, and the only

84. *Id.* at 1342. The Tax Court determined that the fair market value of Blount's stock was $8.2 million (eighty-three percent of $9.85 million), but limited the amount assessed to the value determined by the Service in its initial notice of deficiency. *Id*.

85. I.R.C. §§ 2031(a), 2033 (2000).

86. *See generally* True v. Comm'r, 390 F.3d 1210, 1218 (10th Cir. 2004).

87. *See* I.R.C. § 2703 (2000); Treas. Reg. § 25.2703-1(b) (2005).

88. *Estate of Blount*, 428 F.3d at 1343.

89. *Id*.

90. *Id*.

91. *Id*. at 1343-44.

92. *Id*. at 1344.

93. *Id*.

person on its board of directors, the Eleventh Circuit concluded that Blount had a unilateral ability to modify the agreement.[94]

The Eleventh Circuit also held that the 1996 Agreement was not comparable to similar arrangements entered into at arm's length because the taxpayer's witness testifying to such comparability used only an income-based calculation. Thus, the Eleventh Circuit concluded that the taxpayer's witness understated BCC's value by approximately $2 million compared to the other two experts' valuations.[95]

Finally, the Eleventh Circuit reversed the Tax Court's holding that the fair market value of Blount's shares should be determined by adding the insurance proceeds that BCC received on Blount's death.[96] The Eleventh Circuit reasoned that BCC's insurance on Blount's life should not factor into the valuation of Blount's shares because the insurance proceeds are offset by BCC's liability to pay a like amount to Blount's estate.[97] To support its conclusion, the Eleventh Circuit cited *Estate of Cartwright v. Commissioner*[98] and *Estate of Huntsman v. Commissioner*[99] for the proposition that insurance proceeds should be deducted from the value of a company when they are offset by an obligation to pay those proceeds to the estate in a stock buyout.[100] This conclusion is somewhat questionable.

In *Estate of Huntsman*, the Tax Court valued closely held stock of a steel fabricating company and an industrial supplies company of which decedent was the sole stockholder, president, and treasurer, by taking into account, among other things, the companies' proceeds from life insurance policies on the decedent's life.[101] The Tax Court held that the insurance proceeds should not be added to the value of the decedent's stock after the determination of the value of the companies' assets. However, the Tax Court also held that the insurance proceeds should be treated as one of the nonoperating assets of the companies, and as such, should be considered in the valuation of the companies.[102] Thus, *Estate of Huntsman* stands for the proposition that insurance proceeds payable to a company should be taken into consideration as company assets, and not mechanically added to the value of the stock as determined through the combination of an income-based and an assets-

94. *Id*.
95. *Id*.
96. *Id*. at 1345.
97. *Estate of Blount*, 428 F.3d at 1345.
98. 183 F.3d 1034, 1038 (9th Cir. 1999).
99. 66 T.C. 861, 875 (1976).
100. *Estate of Blount*, 428 F.3d at 1345.
101. *Estate of Huntsman*, 66 T.C. at 862-70.
102. *Id*. at 874-75.

based approach.[103] Therefore, the decision in *Estate of Huntsman* differs from the one in *Estate of Blount*, in which the Eleventh Circuit held that the insurance proceeds are not taken into consideration at all when calculating the assets of the company.[104]

Similarly, as pointed out by the Tax Court, *Estate of Cartwright* is also at least partially distinguishable from *Estate of Blount*.[105] *Estate of Cartwright* concerned a law firm (organized as a C corporation) that entered into a buy-sell agreement with its majority shareholder, pursuant to which the firm undertook to purchase the shareholder's shares and his interest in the fees for the firm's work in progress at the time of the shareholder's death, in exchange for the proceeds from two $2.5 million life insurance policies owned by the corporation on the shareholder's life.[106] The taxpayer took the position that the entire $5 million was paid for the shareholder's stock, whereas the Commissioner determined that approximately $4 million was paid for the shareholder's interest in work in progress and, therefore, was income with respect to a decedent.[107] In determining the fair market value of the stock, the Ninth Circuit rejected the taxpayer's argument that the $5 million in insurance proceeds should be treated as a nonoperating asset of the firm, augmenting the value of its stock, on the grounds that the insurance proceeds were offset by the firm's obligation to pay them over to the estate "dollar for dollar."[108] In so concluding, the court relied on *Estate of Huntsman*, without analyzing the facts or the holding of that case.[109]

The facts in *Estate of Cartwright* are partially distinguishable from the facts in *Estate of Blount*. As previously noted, a substantial portion of the law firm's obligations to its major shareholder were not obligations of the law firm to redeem its stock, but were compensation for the decedent's services. Thus, unlike BCC's liability to Blount's estate, eighty percent of the law firm's liability to Cartwright's estate was no different from any third-party liability and should therefore be netted against the law firm's assets, including its insurance proceeds.[110]

---

103. *Id*.
104. *See Estate of Blount*, 428 F.3d at 1346.
105. Estate of Blount, 87 T.C.M. (CCH) 3, 84-85 (2004).
106. *Estate of Cartwright*, 183 F.3d at 1035-36.
107. *Id*. at 1036.
108. *Id*. at 1038.
109. *Id.* Because the insurance proceeds were not included as one of the assets of the law firm, the applicability of the *Huntsman* holding is somewhat questionable.
110. *Estate of Blount*, 87 T.C.M (CCH) at 84.

The Eleventh Circuit's holding in *Estate of Blount* is also questionable as a policy matter. As the Tax Court noted in its decision that was partially reversed by the Eleventh Circuit:

> [T]he redemption obligation should not be treated as a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued . . . . Valuing decedent's . . . shares by means of the hypothetical willing buyer/seller construct necessarily requires that the corporation's actual obligation to redeem the shares be ignored; such a stance is inherent in the fiction that the shares are being sold to a hypothetical third-party buyer on the valuation date rather than being redeemed by the corporation.
>
> . . . .
>
> A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $500,000. If, at B's death, X's $500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $500,000 ($1 million cash less a $500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $250,000 (i.e., one half of the corporation's $500,000 value) upon B's death. Yet if B's shares are then redeemed for $500,000, A's shares are then worth $500,000—-that is, A's 50 shares constitute 100-percent ownership of a corporation with $500,000 in cash.
>
> It cannot be correct either that B's one-half interest in $1 million in cash is worth only $250,000 or that A's one-half interest in the remainder shifts from a value of $250,000 preredemption to a value of $500,000 postredemption.
>
> The error with respect to B's shares in the example lies in the treatment of X's redemption obligation as a claim on corporate assets when valuing the very shares that would be redeemed with those assets. With respect to A's shares, a willing buyer would pay $500,000 upon B's death (not $250,000) because he *would* take account of both the liability arising from X's redemption obligation *and* the shift in the proportionate ownership interest of A's shares occasioned by the redemption— but never the former without the latter.[111]

It appears that the Eleventh Circuit's holding on this issue, while questionable, may be rooted in its sympathy for Blount's estate. Unlike in most other estate tax cases, Blount's initiation of the 1996 Amend-

---

111. *Id*. at 80-83.

ment does not appear to have been prompted by tax planning considerations. Instead, the 1996 Amendment appears to have been motivated by Blount's concern for the future of BCC, and more particularly for the well-being of BCC's employees, who, after the redemption of Blount's shares, would remain the sole shareholders of BCC.[112] Thus, in addition to reducing the amount of taxes that Blount's estate would have to pay, the 1996 Amendment actually reduced the economic consideration that Blount's estate was to receive upon Blount's death, making the valuation of Blount's shares at a much higher fair market value an "unjust result."[113] The desire to partially mitigate this harsh result may have prompted the Eleventh Circuit to reach the questionable conclusion that BCC's receipt of the insurance proceeds should be excluded from the value of BCC's stock.

IV. DISTRICT COURT CASE—MEDICAL RESIDENTS DO NOT QUALIFY FOR STUDENT EXEMPTION FROM FICA TAX

In *United States v. Mount Sinai Medical Center*,[114] the United States District Court for the Southern District of Florida concluded that medical residents employed by a teaching hospital did not qualify for the student exemption from social security taxes, meaning that the hospital was required to withhold and pay over such taxes to the government.[115]

This case concerned all sixteen quarters of the years 1996 to 1999. During that time, Mount Sinai Medical Center of Florida, Inc. ("Mount Sinai") withheld and paid Federal Income Contribution Act ("FICA")[116] taxes from medical residents' wages.[117] In 2000 and 2001, Mount Sinai filed claims for refunds of these FICA taxes, on the grounds that (1) the fellowship grants and the amounts paid to residents in training were not "payments for services" under section 117(c) of the Code,[118] and (2) the amounts paid to medical residents should have been excluded from FICA wages under the student exemption found in 42 U.S.C.

---

112. *Estate of Blount*, 428 F.3d at 1340; *Estate of Blount*, 87 T.C.M. (CCH) at 5-6. None of Blount's heirs had stock in BCC or was employed by BCC, and Blount did not have a personal relationship with any of BCC's employees outside of work. *Estate of Blount*, 87 T.C.M. (CCH) at 5-6.

113. *See Estate of Blount*, 428 F.3d at 1340-41. As the Eleventh Circuit noted, Blount's heirs were independently wealthy and therefore Blount was not concerned about their financial well-being.

114. 353 F. Supp. 2d 1217 (S.D. Fla. 2005).

115. *Id.* at 1224, 1230.

116. *See* I.R.C. §§ 3101 *et seq.* (2000).

117. *Mount Sinai*, 353 F. Supp. 2d at 1218-19.

118. I.R.C. § 117(c) (2000).

§ 410(a)(10)[119] and section 3121(b)(10) of the Code.[120] A refund of $2,450,177.32, constituting tax and interest, was paid to Mount Sinai. The government, contending that the payments by Mount Sinai were properly paid and withheld FICA taxes, filed a complaint, alleging an erroneous refund and seeking the repayment of the taxes plus interest.[121] Having conceded that the salaries paid to its residents were not exempt under section 117(c), Mount Sinai's claim rested on the student exemption.[122]

Section 3101 of the Code[123] imposes FICA taxes on the wages received by individuals "with respect to employment."[124] Section 3121(b) of the Code defines the term "employment" as "any service, of whatever nature, performed . . . by an employee for the person employing him . . . ."[125] However, section 3121(b)(10) excepts services performed in the employ of:

> (A) a school, college, or university, or
> (B) an organization described in section 509(a)(3) if the organization is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of a school, college, or university and is operated, supervised, or controlled by or in connection with such school, college, or university, unless it is a school, college, or university of a State or a political subdivision thereof and the services performed in its employ by a student referred to in section 218(c)(5) of the Social Security Act are covered under the agreement between the Commissioner of Social Security and such State entered into pursuant to section 218 of such Act;
> if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university[.][126]

In granting summary judgment to the government, the district judge rejected Mount Sinai's argument that its residents fell under the student exception, writing that:

> The student exception does not include [Mount Sinai's] medical residents. Instead, as a matter of law, during the period at issue, medical residents were covered under the social security system, and they, and their employers, are subject to social security taxes. . . . [A]s

---

119. 42 U.S.C. § 410(a)(10) (2000).
120. I.R.C. § 3121(b)(10) (2000); *Mount Sinai*, 353 F. Supp. 2d at 1219.
121. *Mount Sinai*, 353 F. Supp. 2d at 1218.
122. *Id.* at 1222.
123. I.R.C. § 3101 (2000).
124. *Id.* § 3101(a).
125. I.R.C. § 3121(b).
126. *Id.* § 3121(b)(10).

> a matter of law, medical residents are not students under the student exemption to social security and, therefore, their wages are subject to social security taxes.[127]

In reaching its decision that medical residents do not fall under the student exception, the court first noted that the terms "employment" and "wages" should be construed broadly in this context to promote broad coverage under social security.[128] Quoting the United States Supreme Court, the district court explained that "federal social security legislation is an attack on recognized evils in our national economy, [and thus] a constricted interpretation of the phrasing by the courts would not comport with its purpose."[129]

Next, the court described the history of various exceptions to social security coverage to show that medical residents have never been excluded from social security taxation.[130] Under prior versions of the Code, medical interns were separately exempted from social security.[131] However, according to the legislative history of the medical intern exception, medical residents were excluded from this exception, a practice that many medical residents felt was unfair because the distinction between interns and residents had blurred.[132] Congress, rather than expanding the intern exception, eliminated it altogether in 1965, stating that interns were brought within the coverage of social security.[133] The legislative history of the repeal of the intern exception in 1965 does not suggest, according to the court in *Mount Sinai*, that Congress intended for medical residents to qualify for the student exception:

> [T]he focus of an intern's and a resident's service was educational in 1939, remained educational in 1965, and remains educational today. The parties do not dispute that the purpose of a medical residency is to train young doctors. However, nothing suggests that in 1965,

---

127. *Mount Sinai*, 353 F. Supp. 2d at 1222.

128. *Id.*

129. *Id.* at 1222-23 (quoting United States v. Silk, 331 U.S. 704, 712 (1947)).

130. *Id.* at 1223-24.

131. *Id.* at 1223. The court explains the differences among medical students, interns, and residents as follows:

> A medical student is a person who is pursuing a course of study at a medical school and has not yet received a terminal medical degree (*e.g.*, M.D., D.D.S., D.P.M.). A medical resident is a person who has received such a degree and is undergoing further training in a medical or dental specialty. An intern is a resident in his or her first year of training out of medical school.

Id. at 1219.

132. *Id.* at 1225.

133. *Id.* at 1226.

> Congress was unaware of the educational components of an internship or residency, and, when eliminating the intern exception in 1965, Congress made no mention of the possibility that interns and residents could qualify for the student exception.[134]

Finally, the court refused to follow two recent cases suggesting that medical residents may qualify for the student exception, distinguishing one and rejecting the other.[135] In *Minnesota v. Apfel*,[136] the Eighth Circuit held that medical residents at the University of Minnesota Medical Center, even if considered to be state employees, were excluded from FICA taxation pursuant to the State's 1958 modification of its section 418[137] agreement with the Commissioner.[138] The court in *Mount Sinai* distinguished *Apfel*, noting that that case was decided under the terms of an agreement between the State of Minnesota and the Social Security Administration concerning which employees would be subject to social security.[139] In *United States v. Mayo Foundation*,[140] the United States District Court for the District of Minnesota held that medical residents may qualify for the student exception, depending on the facts and circumstances of the residency program.[141] The court in *Mount Sinai* rejected the reasoning of the district court in *Mayo Foundation* by pointing out that "more than 7,000 claims have been filed with the [Service] seeking refunds of over $1.135 billion of social security taxes paid by residents and hospitals, based on an argument that medical residents are excepted from social security coverage."[142] Noting that each of those claims would involve unique facts necessitating separate trials, the court wrote that "[i]t is difficult to imagine that Congress intended to create [this] result."[143] The court in *Mount Sinai* thus found that, as a matter of law, medical residents are covered by social security.[144] The court in *Mount Sinai* thus effectively reasoned that, even if treating medical residents as covered by social security as a matter of law were a mistake (as concluded by the

---

134. *Id.* at 1227.
135. *Id*. at 1229 (citing Minnesota v. Apfel, 151 F.3d 742 (8th Cir. 1998) and United States v. Mayo Found., 282 F. Supp. 2d 997 (D. Minn. 2003)).
136. 151 F.3d 742 (8th Cir. 1998).
137. 42 U.S.C. § 418 (2000).
138. *Apfel*, 151 F.3d at 744, 747-48.
139. *Mount Sinai*, 353 F. Supp. 2d at 1229.
140. 282 F. Supp. 2d 997 (D. Minn. 2003).
141. *Id.* at 1006-07.
142. *Mount Sinai*, 353 F. Supp. 2d at 1229.
143. *Id.*
144. *Id.* at 1230.

court in *Mayo Foundation*), correcting a mistake of this magnitude would cost too much.[145]

145. *See id.*