

Federal Taxation

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I. INTRODUCTION

The courts in the Eleventh Circuit heard a number of relatively prominent tax related cases in 2007. In *United States v. Mount Sinai Medical Center of Florida, Inc.*,¹ the Eleventh Circuit held that medical residents are potentially eligible for the student exemption from social security taxes, with their eligibility being determined on a case-by-case basis.² In *Estate of Jelke v. Commissioner*,³ the Eleventh Circuit vacated the United States Tax Court's valuation methodology in computing, for estate tax purposes, the net asset value of a holding company in which the decedent held a minority interest.⁴ The Eleventh Circuit held that the decedent's estate should be allowed a full dollar-for-dollar discount for the tax liability associated with the built-in gain in the holding company's assets.⁵ In addition, in *Womack v. Commissioner*,⁶ the Eleventh Circuit joined the list of federal courts of appeals that have consistently held that the proceeds from the sale of rights to future

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1. 486 F.3d 1248 (11th Cir. 2007).
2. *Id.* at 1253.
3. 507 F.3d 1317 (11th Cir. 2007).
4. *Id.* at 1319.
5. *Id.*
6. 510 F.3d 1295 (11th Cir. 2007).

installment payments of state lottery winnings are taxed as ordinary income, rather than as capital gains.⁷ In a long and very fact-intensive opinion in *Estate of Kanter v. Commissioner*,⁸ the Tax Court, on remand from the Eleventh Circuit,⁹ upheld its earlier finding that Claude M. Ballard and others had fraudulently failed to report income from a kickback scheme.¹⁰ In *United States v. Coastal Utilities, Inc.*,¹¹ the United States District Court for the Southern District of Georgia granted the government's motion for summary judgment and held that universal support payments received by a telephone company from the federal government and access funds received from Georgia were income to a telephone company, not contributions to capital not subject to tax.¹² Finally, in *Brandon Ridge Partners v. United States*,¹³ the United States District Court for the Middle District of Florida denied a partnership's motion for summary judgment and held that the extended six-year statute of limitations applied to allow an adjustment of partnership items related to a tax shelter transaction.¹⁴

II. ELEVENTH CIRCUIT CASES

A. *Eligibility of Medical Residents for Student Exemption from Social Security Taxes Must Be Determined on a Case-By-Case Basis*

In *United States v. Mount Sinai Medical Center of Florida, Inc. (Mount Sinai II)*,¹⁵ the United States Court of Appeals for the Eleventh Circuit, reversing a district court decision, held that medical residents are potentially eligible for the student exemption from social security taxes under the Federal Insurance Contributions Act ("FICA").¹⁶

Under FICA, both employers and employees are taxed on wages that employers pay to their employees as remuneration for "employment."¹⁷ These taxes are used to fund the federal social security program.¹⁸ The

7. *Id.* at 1307.

8. 93 T.C.M. (CCH) 721 (2007).

9. *Ballard v. Comm'r*, 429 F.3d 1026, 1032 (11th Cir. 2005).

10. *Estate of Kanter*, 93 T.C.M. (CCH) at 805.

11. 483 F. Supp. 2d 1232 (S.D. Ga. 2007).

12. *Id.* at 1251. On January 23, 2008, the Eleventh Circuit affirmed the district court's decision in a per curiam opinion that adopted the district court's order in full. *See United States v. Coastal Utils., Inc.*, 514 F.3d 1184 (11th Cir. 2008) (per curiam).

13. No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129 (M.D. Fla. July 30, 2007).

14. *Id.* at *12.

15. 486 F.3d 1248 (11th Cir. 2007).

16. *Id.* at 1253; I.R.C. §§ 3101-3128 (2000 & Supp. V 2005).

17. I.R.C. §§ 3101(a)-(b), 3111(a)-(b) (2000 & Supp. V 2005).

18. *Mount Sinai II*, 486 F.3d at 1250.

term “employment” is defined, for FICA purposes, as “any service, of whatever nature, performed . . . by an employee for the person employing him.”¹⁹ A number of relationships are excluded from the definition of employment.²⁰ Among these exclusions is the “student exemption,” which covers any “service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university.”²¹

In 2002 the United States brought a complaint against Mount Sinai Medical Center of Florida, Inc. (“Mount Sinai”), claiming that the Internal Revenue Service (the “Service”) had issued to Mount Sinai an erroneous refund in the amount of \$2,450,177 in 2000 and 2001. This amount was attributable to FICA taxes paid and withheld by Mount Sinai for payments made to medical residents in Mount Sinai’s graduate medical education program for the tax years of 1996 through 1999.²² The medical residents who enrolled in the program did not pay tuition or fees, but rather received either uniform salaries or stipends from Mount Sinai to perform medical functions in the medical center. The medical residents also participated in an educational program that included numerous conferences, core curriculum classes, graded examinations, and textbook readings.²³ Based on the educational aspects of the medical residency program, Mount Sinai contended that the refund was proper because the underlying payments to its medical residents fell under the student exemption from FICA taxation.²⁴

In 2005 the United States District Court for the Southern District of Florida determined that the student exemption to FICA does not cover wages paid to medical residents.²⁵ The court first noted that the terms “employment” and “wages” should be construed broadly in this context to promote broad coverage under social security.²⁶ Quoting the United States Supreme Court, the district court explained that “federal social security legislation is an attack on recognized evils in our national

19. I.R.C. § 3121(b) (2000).

20. *Id.*

21. *Id.* § 3121(b)(10).

22. *United States v. Mount Sinai Med. Ctr. of Fla., Inc. (Mount Sinai I)*, 353 F. Supp. 2d 1217, 1218-19 (S.D. Fla. 2005).

23. *Id.* at 1220.

24. *Id.* at 1219.

25. *Id.* at 1230. For a more detailed discussion of the district court’s decision, see Michael H. Plowgian, Svetoslav S. Minkov & T. Wesley Brinkley, *Federal Taxation*, 57 MERCER L. REV. 1115, 1130 (2006).

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

economy, [and thus] a constricted interpretation of the phrasing by the courts would not comport with its purpose.”²⁷

The court next turned to the legislative history of the student exemption and the related exemptions that have, at different times, applied to doctors.²⁸ In particular, the court focused on the since-repealed medical intern exception to FICA tax, which exempted payments for “[s]ervice performed as an interne in the employ of a hospital by an individual who has completed a four years’ course in a medical school chartered or approved pursuant to [s]tate law.”²⁹ The medical intern exception was added to the Internal Revenue Code in 1939.³⁰ According to the district court’s opinion, the House Report accompanying the 1939 amendments “made clear that the [medical] intern exception did not apply to [medical] residents,”³¹ but instead applied only to medical interns, who are generally defined as individuals in the first year of a medical residency program.³² A similar exception covered self-employed physicians.³³ As a result, between 1939 and 1965, many medical residents were subject to FICA tax even though they were exempt from FICA prior to becoming medical residents and would likely be exempt again once they became practicing physicians.³⁴ In *St. Luke’s Hospital Ass’n v. United States*,³⁵ the United States Court of Appeals for the Sixth Circuit acknowledged the seeming inequity of this regime as applied to medical residents.³⁶ Nonetheless, the court held that medical residents were subject to FICA tax while medical interns and self-employed physicians were not.³⁷ Rather than expanding the exceptions to include medical residents, however, Congress responded to *St. Luke’s* in 1965 by repealing the medical intern and self-employed physician exceptions.³⁸

The district court in *Mount Sinai I* determined that based on the legislative history of the 1965 amendments, Congress repealed the

27. *Id.* at 1223 (quoting *United States v. Silk*, 331 U.S. 704, 712 (1947)).

28. *Id.* at 1223-24.

29. *Id.* at 1223 (quoting Social Security Act Amendments of 1939, Pub. L. No. 76-379, § 601, 53 Stat. 1360, 1385).

30. *Id.*; § 601, 53 Stat. at 1385.

31. *Mount Sinai I*, 353 F. Supp. 2d at 1223 (citing H.R. REP. NO. 76-728 (1939), reprinted in 1939-2 C.B. 538, 550-51).

32. *Id.* at 1219.

33. *See id.* at 1224.

34. *Id.* at 1225.

35. 333 F.2d 157 (6th Cir. 1964).

36. *Mount Sinai I*, 353 F. Supp. 2d at 1225-26; *see St. Luke’s*, 333 F.2d at 164.

37. *St. Luke’s*, 333 F.2d at 160.

38. *Mount Sinai I*, 353 F. Supp. 2d at 1226, citing to Social Security Amendments of 1965, § 311(B)(1), 79 Stat. 381.

medical intern exception in order to include medical interns within the social security program, not, as Mount Sinai had posited, because the student exemption already covered medical interns.³⁹ Based on Congress's intent to narrow the exceptions to FICA, as well as Congress's knowledge of the Sixth Circuit's decision in *St. Luke's*, the district court determined that Congress did not intend to exempt medical residents from FICA taxation and found in favor of the government.⁴⁰

On appeal, the Eleventh Circuit reversed and remanded the case to the district court, holding that the lower court's reliance on legislative history was improper.⁴¹ The Eleventh Circuit criticized the district court's failure to analyze whether the language of the student exemption was ambiguous before turning to the legislative history of the statute for guidance.⁴² Performing its own analysis of the language of the student exemption, the court of appeals concluded that the statute's language was not ambiguous and therefore did not, as a matter of law, preclude Mount Sinai "from attempting to prove that its residents' services qualify for the student exemption."⁴³ Instead, the court determined that the statute prompted a factual inquiry into whether a medical resident in Mount Sinai's residency program is a "student" and whether he or she is employed by a "school, college, or university."⁴⁴ Such a factual inquiry is not contrary to the FICA statutory scheme, the court reasoned, because medical residents are not excluded from the student exemption by the exemption's language, and no separate provision mandates FICA taxation of payments to medical residents.⁴⁵ The Eleventh Circuit disagreed with the government's assertion that the court should adopt a bright-line rule that medical residents can never be covered by the student exemption.⁴⁶ The court held that a "case-by-case analysis" was necessary to determine whether the exemption applies to medical residents.⁴⁷

Despite the Eleventh Circuit's determination that the legislative history of the student exemption was not controlling in this case, the court analyzed the legislative history relied upon by the district court and found it unpersuasive.⁴⁸ The court was not persuaded by the

39. 353 F. Supp. 2d at 1227.

40. *Id.* at 1227-28, 1230.

41. *Mount Sinai II*, 486 F.3d at 1253.

42. *See id.* at 1251.

43. *Id.* at 1252.

44. *Id.* at 1253 (quoting I.R.C. § 3121(b)(10)).

45. *See id.* at 1252.

46. *Id.* at 1253.

47. *Id.*

48. *Id.* at 1252-53.

decision in *St. Luke's* because the Sixth Circuit opinion only analyzed whether the medical intern exception, not the student exemption, applied to medical residents.⁴⁹ Consequently, “[t]he fact that Congress repealed the entirely separate [medical] intern exemption in 1965,” in the wake of *St. Luke's*, “is irrelevant to the question of whether [medical] residents may qualify for the student exemption under the plain language of the statute.”⁵⁰ The Eleventh Circuit likewise dismissed the district court’s determination that the Eleventh Circuit’s reading of the student exemption would have rendered the medical intern exemption superfluous if it applied to medical residents.⁵¹ According to the court of appeals, the medical intern exception would have been superfluous only if one assumed that a medical intern was always a “student” and that a “hospital” was always a “school, college, or university,” which the Eleventh Circuit concluded was not a fair assumption.⁵²

The Eleventh Circuit largely bypassed an analysis of the legislative history of the FICA exemptions at issue and, in the process, abandoned a bright-line rule for a standard that could be the catalyst for litigation concerning any number of hospitals with medical residency programs. The Sixth Circuit’s holding in *St. Luke's* and the ensuing congressional contraction of the FICA exemptions applicable to medical school graduates suggests that Congress intended to maintain the application of FICA taxation to medical residents. To justify its decision not to consider the legislative history of the student exemption, the court of appeals pointed out, correctly, that the district court omitted a discussion of the ambiguity of the student exemption’s language. The district court’s analysis of the legislative history suggests, however, that the court found the meaning of “student” and “school, college, or university” to be ambiguous within the context of the student exemption. In addition, the Eleventh Circuit provided very little analysis as to why the student exemption is not ambiguous. The Eleventh Circuit thus ensured that factual analyses of medical residency programs will have to be conducted in the courts on a regular basis in order to enforce the student exemption in the manner Congress intended.

49. *Id.* at 1253.

50. *Id.*

51. *Id.*

52. *Id.* (quoting I.R.C. § 3121(b)(10)).

B. Value of a Holding Company Is Reduced for Estate Tax Purposes by the Full Amount of the Tax Liability on the Built-In Gain of the Company's Assets

In *Estate of Jelke v. Commissioner*,⁵³ the Eleventh Circuit vacated the Tax Court's valuation methodology in computing, for estate tax purposes, the net asset value of a holding company in which the decedent held a minority interest.⁵⁴ The Tax Court held that in determining the net asset value of the holding company, the estate should be allowed only a partial discount for the tax liability associated with the built-in gain in its assets. The Tax Court determined that the discount should equal the present value of the company's expected tax liability resulting from the future sales of the company's assets, projected based on the company's historic rate of disposition of assets.⁵⁵ The Eleventh Circuit held that the decedent's estate should instead be allowed a full dollar-for-dollar discount for the tax liability associated with the built-in gain in the holding company's assets as though the company had sold all of its assets and paid the resulting tax on the date of the decedent's death.⁵⁶

Frazier Jelke III ("Jelke") died in March 1999.⁵⁷ Jelke owned 6.44% of the stock of the Commercial Chemical Company ("CCC"), a closely-held holding company that was taxed as a C corporation and owned appreciated marketable securities.⁵⁸ On the date of Jelke's death, CCC's net asset value, without regard to tax liabilities, equaled approximately \$188 million. CCC also had approximately \$51 million of built-in contingent capital gains tax liability.⁵⁹ CCC was a long-term investment vehicle and had an annual asset turnover of six percent.⁶⁰ The CCC shareholders, other than Jelke, were irrevocable trusts (one of which could not be liquidated prior to 2019), the beneficiaries of which were all Jelke family members.⁶¹ Prior to Jelke's death, there was no intent to liquidate CCC.⁶²

On its federal estate tax return, Jelke's estate valued Jelke's stock in CCC at \$4,588,155. The estate calculated that figure by reducing CCC's net asset value by its \$51 million contingent capital gains tax liability,

53. 507 F.3d 1317 (11th Cir. 2007).

54. *Id.* at 1319.

55. *Id.* at 1318-19.

56. *Id.* at 1319.

57. *Id.*

58. *Id.* at 1318 & n.3.

59. *Id.* at 1319.

60. *Id.*

61. *Id.* at 1320 n.7.

62. *Id.* at 1319.

taking a twenty percent discount for lack of control and a thirty-five percent discount for lack of marketability. The Service issued a notice of deficiency, determining that the value of Jelke's stock in CCC was \$9,111,000. The Service used no discount for the built-in capital gains taxes and used smaller discounts for the lack of control and lack of marketability. In the Tax Court, Jelke's estate contested the Service's determination of the fair market value of Jelke's CCC stock and also contested the proper discounts for lack of control and lack of marketability. The Tax Court rejected the Jelke estate's argument that in determining the fair market value of the CCC stock, a dollar-for-dollar discount for CCC's contingent built-in capital gains tax liabilities should be allowed. Instead, the Tax Court determined that the estate should be allowed a partial discount of \$21 million, which was equal to the present value of the company's expected tax liability resulting from the sale of the company's assets over a sixteen-year period (based on the company's historic turnover rate of six percent).⁶³ The Tax Court also applied a ten percent discount for lack of control and a fifteen percent discount for lack of marketability, which the Eleventh Circuit summarily affirmed.⁶⁴ The Eleventh Circuit disagreed, however, with the Tax Court's discount with respect to the contingent built-in capital gains tax liability.⁶⁵

To give some background to the legal issues in this case, what follows is a brief review of relevant legislation, administrative regulations and rulings, and judicial decisions affecting both estate tax jurisprudence and the methodology for valuing built-in capital gains tax. According to §§ 2031(a)⁶⁶ and 2033⁶⁷ of the Internal Revenue Code of 1986, as amended (the "Code"), a taxable estate generally includes all property of the decedent at its fair market value.⁶⁸ Treasury Regulation § 20.2031-1(b)⁶⁹ provides that the fair market value of property is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."⁷⁰ Revenue Ruling

63. *Id.* at 1319-20.

64. *Id.* at 1320 n.10.

65. *Id.* at 1333.

66. I.R.C. § 2031(a).

67. I.R.C. § 2033.

68. I.R.C. §§ 2031(a), 2033. Unless otherwise noted, all section references are to the Code.

69. Treas. Reg. § 20.2031-1(b).

70. *Id.*

59-60⁷¹ provides the foundations for analyzing the value of stock of closely held investment holding companies.⁷² In particular, section 5(b) of Revenue Ruling 59-60 states that “[t]he value of the stock of a closely held investment . . . holding company, whether or not family owned, is closely related to the value of the assets underlying the stock.”⁷³ Therefore, the net asset value method should be favored in valuing the stock of a closely held investment holding company over the earnings-based method, which is better in valuing operating companies.⁷⁴ However, the application of the net asset value method to contingent built-in capital gains tax liability has undergone a substantial evolution.

Prior to 1986, as a result of the *General Utilities* doctrine, and between 1986 and 1998, as a result of the prior precedents, the courts generally did not allow a deduction for contingent built-in capital gains tax liability in calculating the net asset value of a corporation when a sale or liquidation of the corporation was neither planned nor imminent.⁷⁵ In 1998 however, in *Estate of Davis v. Commissioner*,⁷⁶ the Tax Court determined that in a hypothetical sale of the stock of a closely held corporation that owns marketable securities (when there is no plan for the liquidation of the corporation or a sale of its assets), the buyer of the stock would not disregard the built-in capital gains tax.⁷⁷ Therefore, the court reasoned, the tax should be reflected in the value of the stock of the closely held corporation.⁷⁸ The Tax Court did not allow a separate discount for the built-in capital gains tax, but it treated a part of the marketability discount as due to the built-in capital gains tax.⁷⁹ The court’s holding in *Estate of Davis* was solidified by decisions in the Second, Fifth, and Sixth Circuits that also allowed discounts for built-in

71. Rev. Rul. 59-60, 1959-1 C.B. 237, *modified by* Rev. Rul. 65-193, 1965-2 C.B. 370, *amplified by* Rev. Rul. 77-287, 1977-2 C.B. 319, *amplified by* Rev. Rul. 80-213, 1980-2 C.B. 101, *amplified by* Rev. Rul. 83-120, 1983-2 C.B. 170.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Gen. Utils. & Operating Co.*, 296 U.S. 200 (1935); *see, e.g.*, *Estate of Andrews v. Comm’r*, 79 T.C. 938, 942 (1982) (projected capital gains taxes do not reduce the value of closely held stock when liquidation is only speculative because it is unlikely taxes will ever be incurred); *Estate of Piper v. Comm’r*, 72 T.C. 1062, 1086-87 (1979) (potential capital gains tax discount unwarranted under net asset value method when there is no evidence of a planned liquidation).

76. 110 T.C. 530 (1998).

77. *Id.* at 550.

78. *Id.*

79. *Id.* at 552.

capital gains taxes but did not specify a methodology for the calculation of such discounts.⁸⁰

Finally, in 2002 in *Dunn v. Commissioner*,⁸¹ the Fifth Circuit went one step further and held that as a matter of law, a hypothetical willing buyer or willing seller must always be assumed to immediately liquidate the corporation, triggering a tax on the built-in gain.⁸² Therefore, the court reasoned, a dollar-for-dollar discount should be allowed for the built-in capital gains tax liability.⁸³ The decedent in *Dunn* held a majority interest (but less than what was necessary under state law to cause a liquidation of the corporation) in a family-owned corporation. Eighty-five percent of the corporation's assets were operating assets, and the other fifteen percent of its assets were investment assets.⁸⁴

It is against this backdrop of legislation, administrative decisions, and caselaw that *Jelke* was decided. In *Jelke* the Eleventh Circuit joined the Fifth Circuit and held that as a matter of law, a dollar-for-dollar discount for the contingent built-in capital gains tax liability of a closely held corporation should be allowed in the valuation, for estate tax purposes, of a decedent's interest in that corporation.⁸⁵ In so holding, the Eleventh Circuit dismissed the arguments of the Tax Court and the government that *Dunn* was distinguishable because the decedent in *Dunn* owned a majority interest in a mostly operating company, not a minority interest in an investment holding company.⁸⁶ The Eleventh Circuit reasoned that whether the decedent held a majority or minority interest was irrelevant because the "willing buyer, willing seller"

80. See *Eisenberg v. Comm'r*, 155 F.3d 50, 57 (2d Cir. 1998). In *Eisenberg* the Second Circuit directed the Tax Court to allow a discount for built-in capital gains tax. *Id.* at 57-59. The court did not specify the exact amount of discount but it suggested in dicta that a dollar-for-dollar discount was incorrect. See *id.*; *Estate of Welch v. Comm'r*, No. 98-2007, 2000 WL 263309, at *6 (6th Cir. Mar. 1, 2000) (suggesting that a dollar-for-dollar discount was not warranted). In *Estate of Jameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001), the Tax Court allowed a partial discount for built-in capital gains tax based on its estimate of the net present value of the capital gains tax liability; but the Fifth Circuit remanded the case with instructions to reconsider the amount of the discount. *Id.* at 371, 375.

81. 301 F.3d 339 (5th Cir. 2002).

82. *Id.* at 353.

83. *Id.* at 352-53. In a later decision the Fifth Circuit extended its built-in capital gains tax analysis to contingent liabilities for other estate taxes. See *Succession of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006) (gift tax). However, the Fifth Circuit declined to extend its built-in capital gains tax analysis to whether the value of a decedent's individual retirement accounts should be reduced by the amount of potential income tax liability of the beneficiaries upon distributions from the account. See *Smith v. United States*, 391 F.3d 621, 628-29 (5th Cir. 2004).

84. *Dunn*, 301 F.3d at 346-47.

85. 507 F.3d at 1333.

86. *Id.* at 1331-32.

scenario concerns a hypothetical, and not a strategic, buyer/seller (i.e., someone who will buy and operate the company), and therefore a liquidation should be deemed to have taken place on the date of the decedent's death.⁸⁷ The Eleventh Circuit further reasoned that, although the company in *Dunn* was both an operating and an investment company, the Fifth Circuit's use of different methods to value the company's operating and investment assets negated the government's distinction in that regard was inapposite.⁸⁸

Finally, the Eleventh Circuit reasoned that its holding was partially justified by its desire to provide "certainty and finality" to the valuation of assets for estate tax purposes, an already "vague and shadowy undertaking," and to bypass the "unnecessary expenditure of judicial resources" in evaluating which present value projection was closer to reality.⁸⁹ The Eleventh Circuit described the Tax Court's approach in evaluating the present value of the company's contingent capital gains tax liability as "fluidly ethereal, . . . requir[ing] a type of hunt-and-peck forecasting" that would require courts "to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers [and the government]."⁹⁰ In contrast, the Eleventh Circuit described its dollar-for-dollar approach as a simpler, "more logical and appropriate" approach that did not "resort to present values or prophecies."⁹¹

Circuit Judge Carnes dissented from the majority opinion in *Jelke*, indicating that while the majority's approach might have been simpler, it did not reflect economic reality.⁹² Therefore, Circuit Judge Carnes reasoned that the majority's approach was inaccurate and an unnecessary oversimplification.⁹³

While, from an economic standpoint, the dissenting judge's criticism of the majority holding appears to be well founded, the Eleventh Circuit's approach has its virtues. In particular, while not necessarily reflecting economic reality perfectly, the dollar-for-dollar discount allowed as a matter of law by the Eleventh Circuit would bring certainty and finality to the valuation of contingent built-in capital gains tax liabilities in a taxpayer-friendly manner. More importantly, the

87. *Id.* at 1331.

88. *Id.* at 1331-32.

89. *Id.* at 1332-33.

90. *Id.* at 1332.

91. *Id.*

92. *See id.* at 1335-37 (Carnes, Circuit J., dissenting). Circuit Judge Carnes called the majority's approach a "doctrine of ignoble ease and seductive simplicity," *id.* at 1337, and a "perilous delusion," *id.* at 1340.

93. *See id.* at 1333-40.

Eleventh Circuit's decision would prevent future court proceedings on this question. Thus, the decision, while not easily defensible in its economic underpinnings, is practical and administrable.

C. The Right to Future Payments of Lottery Winnings Is Not a Capital Asset

In *Womack v. Commissioner (Womack II)*,⁹⁴ the Eleventh Circuit, in a consolidated case addressing two unrelated taxpayers, affirmed the Tax Court's holding that the proceeds from the sale of rights to future installment payments from lottery winnings are taxable as ordinary income, not as capital gains.⁹⁵

Roland Womack and Maria Spiridakos (the "Taxpayers") each won a multimillion dollar prize in the Florida State Lottery in 1996 and 1990, respectively. The Florida State Lottery did not offer winners the option of a lump sum payment during the period in which Womack and Spiridakos won their prizes. Instead, their prizes were to be paid out in annual installments. Womack was to receive twenty annual payments of \$150,000, and Spiridakos was entitled to twenty annual installments of \$312,000. Until 2000 Womack and Spiridakos each reported these annual payments on their federal tax returns as ordinary income.⁹⁶

In 1999 the State of Florida amended its law to permit lottery winners to assign their rights to lottery winnings.⁹⁷ In 2000 Womack and Spiridakos each sold the rights to their remaining future installment payments to a finance company for a lump sum payment.⁹⁸ Womack received a payment of \$1.328 million for his sixteen remaining installments, and Spiridakos received a payment of \$2.125 million for her ten remaining installments. Both Womack and Spiridakos reported these lump sum payments as income from the sale of long-term capital assets in 2000.⁹⁹

The government issued notices of deficiency to the Taxpayers for tax year 2000 for amounts attributable to their respective failures to pay tax on the lump sum payments as ordinary income. Each of the Taxpayers filed a petition with the Tax Court seeking a redetermination of the tax

94. 510 F.3d 1295 (11th Cir. 2007).

95. *Id.* at 1297.

96. *Womack v. Comm'r (Womack I)*, 92 T.C.M. (CCH) 410, 411 (2006).

97. *Womack II*, 510 F.3d at 1297.

98. *Womack I*, 92 T.C.M. (CCH) at 411. As required by Florida law, the Taxpayers each obtained Florida Circuit Court approval to assign their respective rights to receive future lottery winnings before making the assignments. *Womack II*, 510 F.3d at 1298 n.1; FLA. STAT. ANN. § 24.1153(1) (West 2003).

99. *Womack I*, 92 T.C.M. (CCH) at 411-12.

due.¹⁰⁰ The Tax Court consolidated the two petitions because the facts in the two cases were alike in every material detail.¹⁰¹ The Tax Court denied both petitions on November 7, 2006. The Taxpayers appealed the case to the Eleventh Circuit.¹⁰²

The Eleventh Circuit, following the precedent established by a number of other circuit courts, affirmed the Tax Court's decision.¹⁰³ The issue before the Eleventh Circuit was whether the gain from the sale of a right to receive future lottery payments was taxable as capital gain or as ordinary income.¹⁰⁴

According to § 1221¹⁰⁵ of the Code, the term "capital asset" is broadly defined as "property held by the taxpayer (whether or not connected with his trade or business)."¹⁰⁶ Also listed under § 1221 are a number of exclusions from the definition of capital asset, but none are directly relevant to the lottery rights at issue in *Womack*.¹⁰⁷ Gain from the sale or exchange of a long-term capital asset, which is defined as a capital asset held by the taxpayer for more than one year, is a capital gain subject to reduced rates of taxation.¹⁰⁸ Other income, or "ordinary income," is taxed at a higher rate.¹⁰⁹ As stated by the Eleventh Circuit, "Congress intended ordinary income to be the default tax rate, with capital gains treatment an exception applicable only in appropriate cases."¹¹⁰ Consequently, the definition of capital asset "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time."¹¹¹

The government argued that the rights to the remaining installment payments were not capital assets because, had the Taxpayers retained those rights, the installment payments would have been ordinary income

100. *Womack II*, 510 F.3d at 1298.

101. *Womack I*, 92 T.C.M. (CCH) at 412. In addition, fifty-seven related cases brought by Florida State Lottery winners were not consolidated with the cases of *Womack* and *Spiridakos*, but the parties in those fifty-seven cases agreed to be bound by the outcome of the consolidated cases in the Tax Court. *Id.* at 411 n.1.

102. *Womack II*, 510 F.3d at 1298.

103. *Id.* at 1300-01, 1307.

104. *See id.* at 1298.

105. I.R.C. § 1221 (2000).

106. *Id.* § 1221(a).

107. *See id.*

108. I.R.C. § 1(h) (2000 & Supp. V 2005).

109. I.R.C. §§ 1, 61, 63, 64 (2000 & Supp. V 2005).

110. *Womack II*, 510 F.3d at 1299.

111. *Id.* (quoting *Comm'r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960)).

to the Taxpayers.¹¹² This argument was based on the substitute for ordinary income doctrine.¹¹³ The basic principle of the doctrine was expressed by the Supreme Court in *Commissioner v. P. G. Lake, Inc.*¹¹⁴ The Tax Court in *Womack I* restated the Court's holding in *P. G. Lake*: "if a taxpayer merely transfers for consideration the right to receive ordinary income in the future, the right transferred will not be treated as a capital asset."¹¹⁵ This doctrine is meant to prevent taxpayers from "circumvent[ing] ordinary income tax treatment by packaging ordinary income payments and selling them to a third party."¹¹⁶ Several other United States Courts of Appeals have considered whether rights to lottery winnings are capital assets,¹¹⁷ and all of these courts have denied capital asset status on the basis of the substitute for ordinary income doctrine.¹¹⁸

The Eleventh Circuit agreed that sales of rights to lottery installment payments "are a clear case of a substitute for ordinary income."¹¹⁹ As illustrated by the Taxpayers' own treatments of the installment payments as ordinary income prior to selling the rights to future payments, a lump sum payment received in exchange for the rights to future installments simply serves as a replacement for future ordinary income.¹²⁰ The Eleventh Circuit listed two primary factors that more specifically justify the application of the substitute for ordinary income doctrine to the sale of future lottery payments.¹²¹ First, the rights to future lottery payments, unlike capital assets, "involve no underlying investment of capital."¹²² Any gain received from the sale of such rights "reflects no change in the value of the asset [but] is simply the amount Taxpayers would have received eventually, discounted to present value."¹²³ Second, even though the income from a lottery payment "does not accrue until the scheduled annual payment date," the right to such lottery payments is "income that is already earned, not a right to

112. *See id.*; *Womack I*, 92 T.C.M. (CCH) at 412.

113. *Womack II*, 510 F.3d at 1299.

114. 356 U.S. 260, 266 (1958).

115. *Womack I*, 92 T.C.M. (CCH) at 413 (citing *P. G. Lake*, 356 U.S. at 266).

116. *Womack II*, 510 F.3d at 1301.

117. *See, e.g.*, *Prebola v. Comm'r*, 482 F.3d 610 (2d Cir. 2007); *Watkins v. Comm'r*, 447 F.3d 1269 (10th Cir. 2006); *Lattera v. Comm'r*, 437 F.3d 399 (3d Cir. 2006), *cert. denied*, 127 S. Ct. 1328 (2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004).

118. *Womack II*, 510 F.3d at 1300.

119. *Id.* at 1301.

120. *See id.*

121. *Id.* at 1301-02.

122. *Id.* at 1301.

123. *Id.*

earn income in the future.”¹²⁴ In contrast, “[a] capital asset has the potential to earn income in the future based on the owner’s actions in using it.”¹²⁵

Lastly, the Taxpayers argued that regardless of the applicability of the substitute for ordinary income doctrine, the lottery rights at issue constituted “property” under § 1221 of the Code, and therefore were capital assets.¹²⁶ The Taxpayers relied on the most general definition of “property,” which includes “anything owned,” even income and any rights or claims to it.¹²⁷ Yet again, the Eleventh Circuit dismissed this theory, stating:

Even if other statutes use “property” in this broad sense, to exclude substitutes for income in determining what constitutes a capital asset is consistent with the word “property.” No other interpretation of “property” would harmonize with the statute’s purpose, as the very nature of the term “capital asset” excludes what is in essence ordinary income.¹²⁸

The Eleventh Circuit in *Womack* joined the other courts of appeals in holding that rights to future lottery payments are not capital assets. While the Eleventh Circuit did analyze each of the arguments raised by the Taxpayers, it appeared that the Taxpayers were never going to be able to overcome the prior precedent on this issue.

III. DISTRICT COURT AND TAX COURT CASES

A. Tax Court Upholds Finding of Fraud in Ballard Case

In *Estate of Kanter v. Commissioner*,¹²⁹ the latest (though perhaps not last) chapter in the *Ballard* saga,¹³⁰ the Tax Court upheld its

124. *Id.* at 1302.

125. *Id.* The Eleventh Circuit also rejected the Taxpayers’ argument that even if the sale of the rights to the future lottery payments would be covered by the traditional substitute for ordinary income doctrine, such rights are not controlled by the doctrine as modified by *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). *Womack II*, 510 F.3d at 1303. The Eleventh Circuit held that *Arkansas Best* was inapposite. *See id.* at 1302-03.

126. *See Womack II*, 510 F.3d at 1305-06.

127. *Id.* at 1304.

128. *Id.*

129. 93 T.C.M. (CCH) 721 (2007).

130. *See Inv. Research Assocs. v. Comm’r*, 78 T.C.M. (CCH) 951 (1999), *aff’d*, *Ballard v. Comm’r*, 321 F.3d 1037 (11th Cir. 2003), *rev’d*, *Ballard v. Comm’r*, 544 U.S. 40 (2005).

earlier finding that Claude M. Ballard and others fraudulently failed to report income from a kickback scheme.¹³¹

The procedural background to this decision is long and convoluted.¹³² The case was heard originally by Tax Court Special Trial Judge D. Irvin Couvillion, who prepared an initial report (the "STJ Report"). Then the case was assigned to Judge Howard A. Dawson, Jr. for adoption of the STJ Report and entry of decision.¹³³ Judge Dawson and Special Trial Judge Couvillion collaborated in preparing the final report, in which the court upheld the government's determination that Ballard and others fraudulently failed to report income from a kickback scheme.¹³⁴ Under Rule 183¹³⁵ of the Tax Court Rules of Practice and Procedure, as in effect at the time, the STJ Report was neither filed nor otherwise entered into the record of the case.¹³⁶

The Tax Court's decision was affirmed by the Eleventh Circuit.¹³⁷ However, the Supreme Court reversed and remanded, concluding that the collaborative process used by the Tax Court was not warranted by Rule 183, and that the STJ Report was required to be included in the record to permit fully informed appellate review.¹³⁸ On remand, the Eleventh Circuit obtained the STJ Report, in which Special Trial Judge Couvillion found that Ballard was not liable for the tax deficiencies asserted against him, concluded that there was no kickback scheme, and held that the government's allegations of fraud were unwarranted.¹³⁹ The Eleventh Circuit remanded the case to the Tax Court, stating:

(1) The "collaborative report and opinion" of the Tax Court is ordered stricken; (2) The original report of the special trial judge is ordered reinstated; (3) The Chief Judge of the Tax Court is instructed to assign this matter to a regular Tax Court Judge who had no involvement in the preparation of the aforementioned "collaborative report;" (4) The Tax Court shall proceed to review this matter in accordance with the dictates of the Supreme Court, and with the Tax Court's newly revised Rules 182 and 183, giving "due regard" to the credibility determina-

131. *Estate of Kanter*, 93 T.C.M. (CCH) at 805.

132. For more detailed discussions of the history of *Estate of Kanter*, see Donald R. Bly & Michael H. Plowgian, *Federal Taxation*, 55 MERCER L. REV. 1313 (2004); Plowgian, Minkov & Brinkley, *supra* note 25.

133. *Estate of Kanter*, 93 T.C.M. (CCH) at 729.

134. *Id.*

135. TAX CT. R. 183.

136. *Estate of Kanter*, 93 T.C.M. (CCH) at 730 (citing *Ballard*, 544 U.S. at 45).

137. *Ballard*, 321 F.3d at 1046.

138. *Ballard*, 544 U.S. at 65. Tax Court Rule 183 was amended in response to the Supreme Court's decision. See *Estate of Kanter*, 93 T.C.M. (CCH) at 730.

139. *Ballard v. Comm'r*, 429 F.3d 1026, 1029 (11th Cir. 2005) (per curiam).

tions of the special trial judge and presuming correct fact findings of the trial judge.¹⁴⁰

The Eleventh Circuit also instructed the Tax Court that the STJ Report's findings of fact were presumed correct "unless manifestly unreasonable."¹⁴¹ Additionally, the Eleventh Circuit stated that rejecting the credibility determination of the original fact-finder (unless a reason for the rejection could be articulated from the trial transcript) would ordinarily require rehearing the testimony, which was foreclosed in this case by the deaths of all the primary witnesses.¹⁴²

On remand, the Tax Court upheld its finding of fraud against Ballard and the other taxpayers, finding that the STJ Report's conclusions and credibility determinations were "manifestly unreasonable."¹⁴³ Under the amended Rule 183,¹⁴⁴ the judge to whom a case is assigned "may adopt the Special Trial Judge's recommended findings of fact and conclusions of law, or may modify or reject them in whole or in part."¹⁴⁵ Thus, the Tax Court did "not feel constrained from correcting manifestly unreasonable findings of fact or making additional findings of fact, so long as any additional facts find direct support in the case record."¹⁴⁶

The Tax Court noted the well-established principle that the findings of fact and credibility determinations made by the presiding judge in a trial are presumed to be correct unless manifestly unreasonable.¹⁴⁷ Based on established caselaw, however, the Tax Court reasoned that it could reject a finding of fact in the STJ Report if "the recommended finding of fact or testimony (1) is internally inconsistent or so implausible that a reasonable fact finder would not believe it, or (2) is not credible because it is directly contradicted by documentary or objective evidence."¹⁴⁸ Finally, the Tax Court concluded that, notwithstanding the fact that it could not retry the case, it could reject the STJ Report's credibility determinations when they were manifestly unreasonable based on the record.¹⁴⁹

140. *Id.* at 1027.

141. *Id.* at 1032.

142. *Id.*

143. *Estate of Kanter*, 93 T.C.M. (CCH) at 788.

144. TAX CT. R. 183 (as amended in 2005).

145. *Estate of Kanter*, 93 T.C.M. (CCH) at 730.

146. *Id.* at 733.

147. *Id.*

148. *Id.* at 735.

149. *Id.*

The Tax Court concluded that the Special Trial Judge misunderstood or misstated the government's theory of the kickback scheme and that this misunderstanding caused the STJ Report's conclusions to be manifestly unreasonable.¹⁵⁰ Fundamentally, the STJ Report gave undue weight to testimony by the ultimate sources of the kickback payments (referred to by the court as "The Five") that they were not involved in a kickback scheme, which caused the STJ Report to overlook substantial evidence of fraud in the record.¹⁵¹ According to the Tax Court, the fact that The Five did not know that they were involved in a kickback scheme was irrelevant.¹⁵² The Five made payments to Kanter, one of the participants in the scheme, who then made kickback payments to the other participants, including Ballard, for funneling business to The Five.¹⁵³ The government's contention was that Kanter, Ballard, and the other defendants fraudulently failed to report those payments properly as income, using a complex web of entities and transactions to hide the income.¹⁵⁴

The Tax Court engaged in a lengthy review of the STJ Report's findings of fact, which it supplemented with additional facts from the record. The Tax Court supported its conclusions in mind-numbing detail, poring through bank statements to trace the flow of funds to Ballard and the other petitioners and comparing their testimony with the objective facts of the record.¹⁵⁵ For example, the Tax Court went through payments made by The Five to Investment Research Associates, Ltd. ("IRA") over the course of thirteen years.¹⁵⁶ The Tax Court then catalogued payments and transfers from IRA to multiple entities controlled by Ballard, Kanter, the other participants, and their respective family members.¹⁵⁷ These transfers, which Ballard did not include as taxable income, included loans to Ballard and his family members that were never repaid, as well as "consulting payments" to Ballard's adult children for no discernible consulting services.¹⁵⁸

The STJ Report, however, contained only a limited discussion concerning loans to certain petitioners and their family trusts, and it did not include an analysis of the flow of funds that the government offered as proof that the payments from The Five constituted taxable income

150. *Id.* at 744, 787.

151. *Id.* at 744.

152. *Id.*

153. *Id.* at 787.

154. *Id.*

155. *See id.* at 767-82.

156. *Id.* at 767.

157. *Id.* at 767-82.

158. *See id.* at 772-73, 776-77.

earned by Ballard and the other petitioners.¹⁵⁹ The STJ Report's failure to analyze the objective facts of the case and its reliance instead on the petitioners' testimony that they were not engaged in fraud was manifestly unreasonable in the Tax Court's opinion.¹⁶⁰

Based on its review of the record, the Tax Court concluded that the testimonies of Ballard and the other petitioners generally were implausible in light of the objective facts of the transactions.¹⁶¹ Moreover, the Tax Court sustained the government's argument that the entities utilized by the petitioners to hide their income were shams that could be disregarded and that the petitioners were required to report that income as their own.¹⁶² Based on these findings, the Tax Court upheld the government's determination that Ballard and the other petitioners filed false and fraudulent tax returns, and thus, the petitioners were liable for additions to tax due to fraud.¹⁶³

It is not clear whether the Tax Court's detailed and thorough analysis will be sufficient to overcome the deference that should be accorded to the STJ Report in light of the opinions by the Supreme Court and the Eleventh Circuit. Given the time and resources already spent on this case, however, we may hope that the Tax Court's decision is the last word in this matter.

B. Universal Service Support Payments to a Telephone Company Are Gross Income, and Not Contributions to Capital

In *United States v. Coastal Utilities, Inc.*,¹⁶⁴ the United States District Court for the Southern District of Georgia granted the government's request for summary judgment and held that both universal support payments received by a telephone company from the federal government and access funds received from Georgia were income to the telephone company, not contributions to capital excluded from tax.¹⁶⁵

Coastal Utilities, Inc. ("Coastal") is a company that provides local and long distance telephone services to residential and business customers in and around Liberty County, Georgia.¹⁶⁶ Coastal maintains a network of loops, switches, and trunks necessary for the provision of

159. *Id.* at 767.

160. *Id.* at 789.

161. *Id.* at 802.

162. *See id.* at 804.

163. *Id.* at 805.

164. 483 F. Supp. 2d 1232 (S.D. Ga. 2007).

165. *Id.* at 1251. On January 23, 2008, the Eleventh Circuit affirmed the district court's decision in a per curiam opinion that adopted the district court's order in full. *See United States v. Coastal Utils., Inc.*, 514 F.3d 1184 (11th Cir. 2008).

166. *Coastal Utils.*, 483 F. Supp. 2d at 1236.

telephone services.¹⁶⁷ The costs per subscriber for providing loops, switches, and trunks in rural areas is higher than the costs in more densely populated areas because the companies (1) cannot take advantage of the economies of scale that carriers enjoy in more densely populated areas, (2) have to maintain longer loop lengths, and (3) often have to overcome challenges of rural topography.¹⁶⁸

Beginning in the early twentieth century, the telephone system of the United States was structured on the belief that every person should have access to a telephone for outgoing calls.¹⁶⁹ The vision of universal service was first incorporated into the Communications Act of 1934¹⁷⁰ and later in the Telecommunications Act of 1996 (the "1996 Act").¹⁷¹ According to section 254(b)(3) of the 1996 Act,¹⁷² "[c]onsumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services . . . at rates that are reasonably comparable to rates charged for similar services in urban areas."¹⁷³ While Congress delegated the responsibility for determining what services must be universally offered and the specific methods to support universal service to the Federal Communications Commission (the "FCC"), Congress also set forth principles upon which the FCC was to base its policies for the preservation and enhancement of universal service.¹⁷⁴ In May of 1997 the FCC issued an order establishing the

167. *Id.* The district court explained:

A "loop" is the circuit that connects a subscriber to Coastal's central switching office. . . . In 1998, Coastal's service area had approximately 38,000 loops.

A "switch" is the piece of equipment that routes each call to the proper recipient based on the digits dialed by the initiator of the call. If the call is a local call, the switch directs the call to the loop that connects to the recipient's premises. If the call is long distance, the switch directs the call to a trunk. A "trunk" is the facility that connects Coastal's network with the networks of other providers, such as long distance companies.

Id.

168. *Id.* at 1236.

169. *Id.* at 1234.

170. Pub. L. No. 73-416, 48 Stat. 1064 (codified as amended at 47 U.S.C. §§ 151-613 (2000)).

171. Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

172. *Id.*, 110 Stat. at 71 (codified at 47 U.S.C. § 254(b)(3) (2000)).

173. *Id.*

174. *Coastal Utils.*, 483 F. Supp. 2d at 1235. Some of those principles included (i) "quality services should be available at just, reasonable and affordable rates," (ii) access to advanced telecommunications should be provided in all regions of the country, (iii) the rates and quality of service for low-income consumers or consumers in rural areas should be reasonably comparable to those in urban areas, and (iv) all providers of telecommunica-

services that must be universally available and indicating that carriers who provide these services are eligible to receive federal universal service support under four programs, including the High Cost Program.¹⁷⁵ A carrier who receives support under the High Cost Program may only use such support “for the provision, maintenance, and upgrading of facilities and services for which the support is intended.”¹⁷⁶

As the district court explained, “the High Cost Program provides qualifying local exchange carriers with funds to extend the telecommunications infrastructure into rural and other high-cost areas where such investment would not otherwise be economically viable.”¹⁷⁷ The program is funded by payments from every telecommunications carrier and includes a variety of funding mechanisms, three of which were applicable to Coastal: (1) High Cost Loop Support, (2) Local Switching Support, and (3) Long Term Support.¹⁷⁸ As the court described these programs:

The High Cost Loop Support mechanism provides funding to rural telephone companies whose average cost per loop is greater than 115% of the nationwide average. The Local Switching Support mechanism provides funds to those companies that serve study areas with 50,000 or fewer loops. These funds support costs incurred in switching calls between loops, if the call is local, or between a trunk and a loop if the call is long distance. The Long Term Support mechanism allows a carrier to recover a portion of loop costs that have been allocated to the provision of interstate services.¹⁷⁹

The State of Georgia also implemented a program that “enabled telephone companies to recover revenues lost as a result of a mandated reduction of intrastate charges,” and Coastal received amounts under that program as well.¹⁸⁰

In its amended federal income tax return for 1998, Coastal excluded from income the universal service support payments it received from both the federal government and Georgia as nonshareholder contributions to capital.¹⁸¹ In June 2004 the United States filed a lawsuit against Coastal that contended the funds Coastal received under the

tions services should make equitable contributions to universal service. *Id.* at 1235 n.3.

175. *Id.* at 1235-36.

176. *Id.* at 1236 (quoting 47 U.S.C. § 254(e) (2000)).

177. *Id.* at 1237.

178. *Id.*

179. *Id.*

180. *Id.* at 1238. The state program is the Georgia Universal Access Fund. *Id.*

181. *Id.* at 1234.

High Cost Program and the Georgia access funds program were includable in gross income as a subsidy.¹⁸²

According to § 61(a)¹⁸³ of the Code, “gross income means all income from whatever source derived.”¹⁸⁴ However, § 118(a)¹⁸⁵ excludes from gross income “any contribution to the capital of the taxpayer.”¹⁸⁶ Treasury Regulation § 1.118-1¹⁸⁷ provides that a contribution to capital can be of either money or property, and that it can be made by shareholders or nonshareholders.¹⁸⁸ The regulation adds:

For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.¹⁸⁹

The legislative history of § 118 indicates that the statute was meant to “place[] in the code the court decisions on this subject.”¹⁹⁰

At the time of the enactment of § 118, “the Supreme Court had issued opinions in several significant cases regarding exclusions for nonshareholder contributions to capital.”¹⁹¹ First, as the district court in *Coastal Utilities* explained, in *Edwards v. Cuba Railroad Co.*:¹⁹²

the Supreme Court held that subsidy payments by the Cuban government for the construction and operation of a railroad did not constitute taxable income. . . . [T]he subsidy payments “were proportionate to mileage completed” and “necessary to construct the railroad.” This indicated a “purpose to reimburse [the taxpayer] for capital expenditures.” Furthermore, the payments . . . were “not made for services

182. *Id.*

183. I.R.C. § 61(a) (2000).

184. *Id.*

185. I.R.C. § 118(a) (2000).

186. *Id.*

187. Treas. Reg. § 1.118-1 (2001).

188. *Id.*

189. *Id.*

190. H.R. REP. NO. 83-1337 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4042; S. REP. NO. 83-1622 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4648.

191. *Coastal Utils.*, 483 F. Supp. 2d at 1238.

192. 268 U.S. 628 (1925).

rendered or to be rendered,” and they were “not profits or gains from the use or operation of the railroad.”¹⁹³

Seven years later, however, in *Texas & Pacific Railway Co. v. United States*,¹⁹⁴ “the Court held that government payments to a railroad to guarantee a minimum operating income were not contributions to capital” because “the ‘purpose of the guaranty provision was to stabilize the credit position of the [rail]roads by assuring them a minimum operating income,’” and thus, the payments were a supplement to income, not a capital contribution.¹⁹⁵

Next, as the district court in *Coastal Utilities* explained in *Detroit Edison Co. v. Commissioner*:¹⁹⁶

the Court held that payments made by prospective customers of an electric company to cover the cost of extending the utility’s facilities to the customers’ homes were part of the price of services and not contributions to capital [b]ecause the transferors made the payments with the intention of receiving a direct benefit in the form of specific services.¹⁹⁷

In *Brown Shoe Co. v. Commissioner*,¹⁹⁸ however, the Supreme Court held that “transfers of cash and other property made by civic groups to induce the taxpayer to build and operate facilities in their communities or expand the facilities already there” were contributions to capital because the contributors’ motivation was “that the transactions would benefit the community at large by providing jobs.”¹⁹⁹ Thus, the decisions in *Detroit Edison* and *Brown Shoe* established that the contributor’s motivation is a primary factor in determining whether a payment is a contribution to capital or income.²⁰⁰

Finally, in 1973 the Supreme Court decided *United States v. Chicago, Burlington & Quincy Railroad Co. (CB&Q)*.²⁰¹ In *CB&Q* the government paid a “railroad to fund improvements to highway crossings, crossing signals, signs, and lighting . . . , but [the railroad] assumed the responsibility of maintaining the facilities at its own expense.”²⁰² “The

193. *Coastal Utils.*, 483 F. Supp. 2d at 1239 (second brackets in original) (citations omitted) (quoting *Edwards*, 268 U.S. at 632-33).

194. 286 U.S. 285 (1932).

195. *Coastal Utils.*, 483 F. Supp. 2d at 1239 (quoting *Tex. & Pac. Ry.*, 286 U.S. at 289).

196. 319 U.S. 98 (1943).

197. *Coastal Utils.*, 483 F. Supp. 2d at 1239 (citation omitted).

198. 339 U.S. 583 (1950).

199. *Coastal Utils.*, 483 F. Supp. 2d at 1240.

200. See *Detroit Edison*, 319 U.S. at 102; *Brown Shoe*, 339 U.S. at 591.

201. 412 U.S. 401 (1973).

202. *Coastal Utils.*, 483 F. Supp. 2d at 1240.

Court held that the government subsidies were not contributions to capital and could not be depreciated.²⁰³ In arriving at its conclusion, the Supreme Court listed five characteristics that indicate that a payment is a contribution to capital and not a subsidy: (i) the funds became “a permanent part of the transferee’s working capital structure,” (ii) the funds were “not [a] compensation” for services, (iii) the funds were bargained for, (iv) the transferred asset resulted in “benefit to the transferee in an amount commensurate with its value,” and (v) the asset was “employed in . . . the production of additional income.”²⁰⁴

In *Coastal Utilities*, both Coastal and the government agreed “that the contributor motivation test and the *CB&Q* factors provide the applicable standard for determining whether the universal [service] support payments were income or a contribution to capital.”²⁰⁵ Based on these tests, the United States District Court for the Southern District of Georgia granted the government’s motion for summary judgment and held that the payments made to Coastal under the High Cost Program and the Georgia Universal Access Funds program were gross income to Coastal, not a contribution to capital.²⁰⁶ In a detailed opinion, the court noted that the method for calculating the amounts of universal support strongly suggested that the purpose of the payments was to supplement Coastal’s income, even though the amounts under the program were largely based on Coastal’s investment expenditures.²⁰⁷ In particular, the court pointed out that the amounts of the universal support payments under all three federal programs were based on an investment return on Coastal’s expenses (including expenses directly related to the provision of universal services and other expenses unrelated to capital investment), and therefore, the payments were supplemental income and not a contribution to capital.²⁰⁸

For example, under the High Cost Loop Support program, Coastal was entitled to receive support equal to 65% of its costs that were between 115% and 150% of the national average cost per loop, and indeed it received \$1,814,115.²⁰⁹ To arrive at Coastal’s cost per loop, however, the FCC included many of Coastal’s operating expenses that were unrelated to either the construction or the maintenance of the loops, such as wages and benefits for employees performing work unrelated to

203. *Id.*

204. *CB&Q*, 412 U.S. at 413.

205. *Coastal Utils.*, 483 F. Supp. 2d at 1241.

206. *Id.*

207. *Id.* at 1241-42.

208. *Id.* at 1242.

209. *Id.*

capital projects, and corporate operating expenses, such as director and officer salaries.²¹⁰ The district court further reasoned that these payments under the High Cost Loop Support program were not calculated based on a proposal to build new loops but instead were based on the total number of working loops, thus indicating the payments were intended to add to the return on Coastal's existing services rather than to pay for expanding and upgrading the infrastructure.²¹¹

Coastal argued that because the purpose behind the concept of universal service was to benefit the public and because the payments were not for particular services, the Supreme Court's decisions in *Detroit Edison* and *Brown Shoe* should have controlled, and the universal service payments should have been a contribution to capital.²¹² The district court reasoned, however, that *Detroit Edison* and *Brown Shoe* stand for the proposition that "if a payment is made in exchange for specific goods and services, then that payment is income and not a contribution to capital," and not for Coastal's proposition that if a payment is made for a public purpose, then such payment would always be a contribution to capital.²¹³ The district court based its conclusion on *CB&Q*, in which "the Supreme Court held that even though the payments were not compensation for services, and were for a more general public benefit," the *CB&Q* factors should determine whether such payments were income or a contribution to capital.²¹⁴

The district court also dismissed Coastal's argument that because "[b]y statute, the High Cost Program Funds may be used 'only for the provision, maintenance, and upgrading of facilities and services for which the support is intended,'" such amounts were pegged to Coastal's investment and should be considered a contribution to capital.²¹⁵ The district court distinguished a return on a previously made investment from the making of a capital investment and reasoned that the universal service funds were not directly paying for a capital expenditure but were giving incentives to telecommunication providers to develop infrastructure by offering them a return on their investment.²¹⁶

In addition, the district court found that "a detailed holding as to each of the five *CB&Q* factors would not [have been] helpful" because some

210. *Id.*

211. *Id.* at 1243. The district court's analysis of the Local Switching Support program and the Long Term Support program was similar. *Id.* at 1243-44.

212. *Id.* at 1245.

213. *Id.*

214. *Id.* (citing *CB&Q*, 412 U.S. at 413-14).

215. *Id.* at 1246 (quoting 47 U.S.C. § 254(e)).

216. *Id.* at 1247.

of the *CB&Q* factors were not clearly applicable to Coastal's case, and the contributor's motivation as previously determined should have controlled the determination of whether the universal support payments should have been treated as gross income or a contribution to Coastal's capital.²¹⁷

Finally, the district court held that because the calculation of the Georgia Universal Access Fund's payments was tailored to reimburse the revenue Coastal lost due to the reduction in its intrastate rates, such funds should also have been income and not a contribution to capital.²¹⁸

The district court's holding is hard to analyze without the benefit of a more detailed description of the methodology utilized in calculating the payments under the High Cost Program. Based on the district court's opinion, it appears that certain costs, which were not directly attributable to the provision of universal telecommunications services, were included in the calculation of the support payments to Coastal under the High Cost Program, and a return on all costs was included in some calculations.²¹⁹ On balance, however, it seems the general intent of the payments under the High Cost Program was to reimburse the telecommunication companies for the additional costs that they incurred in servicing high-cost areas, not to supplement their income.²²⁰ Thus, in the case of the High Cost Loop Support program, Coastal's revenue from the provision of telephone services appears to have had no impact on the amount of the payments that were made to Coastal.²²¹ It is therefore somewhat unclear whether such payments can be fairly classified as supplementing Coastal's income when Coastal's income was not taken into account.²²² Furthermore, the district court's refusal to provide an explicit analysis of the application of the *CB&Q* factors²²³ is perplexing in light of its statement that *CB&Q* is the "seminal case regarding nonshareholder contributions."²²⁴ While the district court's arguments that several of those factors appear inapplicable to Coastal seem convincing, those arguments should not have precluded the district court from analyzing the remaining factors.²²⁵ Nonetheless, the district court's decision was likely informed by a more detailed analysis

217. *Id.* at 1250.

218. *Id.* at 1251.

219. *Id.* at 1248.

220. *Id.*

221. *See id.* at 1242-43.

222. *Id.* at 1248.

223. *Id.* at 1250.

224. *Id.* at 1240.

225. *See id.* at 1248-50.

of the facts than set forth in the published opinion because it had the benefit of reviewing the detailed statements and the parties' explanations about the methods used to calculate the universal support payments.

C. Six-Year Statute of Limitations Applies to Adjustment of Partnership Income from Tax Shelter Transaction

In *Brandon Ridge Partners v. United States*,²²⁶ the United States District Court for the Middle District of Florida denied a partnership's motion for summary judgment after finding that the extended six-year statute of limitations applied to allow the Service to adjust certain items on the partnership's 1998 tax return.²²⁷ The adjustment at issue was made in response to Brandon Ridge Partners' participation in a so-called Son of BOSS²²⁸ tax shelter transaction.²²⁹ Nelson Jefferson was a majority shareholder in Florida Electronic Supply, Inc. ("FES"), a subchapter S corporation.²³⁰ In 1998 Jefferson decided to sell his FES stock, "which had a relatively low basis," and engage in certain transactions to try to reduce his taxable gain on the sale of the FES stock.²³¹ First, Jefferson formed NJ Investments, LLC ("NJI") and Brandon Ridge, Inc., a subchapter S corporation (the "S Corporation"), both wholly owned by Jefferson.²³² Jefferson also formed Brandon Ridge Partners (the "Partnership"), in which Jefferson and his then-wife owned all of the interests.²³³ Next, Jefferson, acting through NJI, engaged in a short sale of treasury notes.²³⁴ NJI borrowed treasury notes and sold them to a third party, retaining the obligation to replace the borrowed treasury notes. NJI then contributed the \$3,258,458 in proceeds from the short sale and the corresponding obligation to replace the treasury notes to the Partnership. Shortly afterward, the Partnership satisfied the obligation on the short sale, and Jefferson contributed

226. No. 8:06-cv-1340-T-24MAP, 2007 WL 2209129 (M.D. Fla. July 30, 2007).

227. *Id.* at *13.

228. *Id.* at *4. Son of BOSS is a variation of a tax shelter known as a "Bond and Option Sales Strategy." For a full description, see *Kligfeld Holdings v. Commissioner*, 128 T.C. 192, 194 (2007).

229. *Brandon Ridge Partners*, 2007 WL 2209129, at *4.

230. *Id.* at *1.

231. *Id.*

232. *Id.* at *2.

233. *Id.* Jefferson owned a ninety-nine percent interest and his then-wife, Carolyn Jefferson, owned a one percent interest in Brandon Ridge Partners. *Id.*

234. *Id.* This Article assumes that NJI is a disregarded entity for tax purposes because the court treats the contribution of the short sale proceeds and liability as contributions by Jefferson himself.

his FES stock to the Partnership as a capital contribution. Thereafter, Jefferson and his wife contributed ninety-nine percent of their interests in the Partnership to the S Corporation.²³⁵

As a result of the above actions, the S Corporation held a ninety-nine percent interest in the Partnership, and Jefferson held the remaining one percent interest.²³⁶ Since Jefferson owned 100% of the S Corporation, both the Partnership and the S Corporation were controlled by Jefferson.²³⁷ Nevertheless, Jefferson's transfer of ninety-nine percent of his interest in the Partnership caused a technical termination of the Partnership under § 708(b)(1)(B)²³⁸ of the Code.²³⁹ The "new" Partnership made an election under § 754²⁴⁰ of the Code, which allows a partnership to adjust the basis of its property in accordance with § 743(b)²⁴¹ of the Code upon the sale or exchange of a partnership interest.²⁴² The adjustment provided for in § 743(b) allows the partnership to "increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property."²⁴³ The Partnership took the position that, as a result of the § 743(b) adjustment, the Partnership's basis in the FES stock was increased by \$3,258,458, which was the S Corporation's purported outside basis in its interest in the Partnership.²⁴⁴ Thus, when the Partnership sold the FES stock for \$3,315,000 to an unrelated third party, the Partnership only reported a gain of \$31,042 on the sale because of the claimed increase in the Partnership's basis in the stock.²⁴⁵

235. *Id.* Jefferson contributed a ninety-eight percent interest in the Partnership to the S Corporation and retained a one percent interest, while Carolyn Jefferson contributed her entire one percent interest in the Partnership to the S Corporation. *Id.*

236. *Id.* at *2 & n.3.

237. *Id.* at *2.

238. I.R.C. § 708(b)(1)(B) (2000). ("[A] partnership shall be considered as terminated . . . if . . . within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.")

239. *Brandon Ridge Partners*, 2007 WL 2209129, at *2.

240. I.R.C. § 754 (2000).

241. I.R.C. § 743(b) (2000 & Supp. V 2005).

242. *Brandon Ridge Partners*, 2007 WL 2209129, at *2; I.R.C. § 754.

243. I.R.C. § 743(b)(1).

244. *Brandon Ridge Partners*, 2007 WL 2209129, at *2. "Inside basis is a partnership's basis in the property which it owns. . . . Outside basis is an individual partner's basis in his interest in the partnership itself." *Id.* at *3 (quoting *Kligfeld Holdings*, 128 T.C. at 196).

245. *Id.* at *2.

On February 22, 2006, the Service issued a notice of Final Partnership Administrative Adjustment (“FPAA”), which notified the parties to the transaction that it intended to adjust the Partnership’s income for the 1998 tax year.²⁴⁶ The Service took the position that the transactions described above lacked economic substance.²⁴⁷ As a result, the Service asserted that the parties to the transactions incorrectly calculated their bases in their partnership interests in several instances. First, when the proceeds of the short sale were contributed to the Partnership, Jefferson’s outside basis in the Partnership was properly increased by the amount of the proceeds contributed.²⁴⁸ However, the Service contended that Jefferson should have simultaneously decreased his outside basis in the Partnership by the value of the obligation to cover the short sale because a partner’s outside basis decreases when the partnership assumes a partner’s liability.²⁴⁹ Consequently, Jefferson’s outside basis in the Partnership, which Jefferson reported as \$3,258,458, was substantially overstated within the meaning of § 6501(e)(1)(A)²⁵⁰ and should have been zero.²⁵¹ Next, Jefferson and his then-wife transferred their interests in the Partnership to the S Corporation, and the S Corporation properly took the same outside basis in the Partnership that Jefferson and his then-wife held before the transfer.²⁵² However, the S Corporation’s outside basis in the Partnership was overstated because Jefferson’s outside basis in the Partnership was likewise overstated.²⁵³ Therefore, when the Partnership made the § 754 election, no adjustment to the basis of the assets was necessary because the S Corporation’s basis in its interest in the Partnership was zero.²⁵⁴ Thus, upon the sale of the FES stock, the Partnership recognized a gain of \$3,289,500 and not \$31,042.²⁵⁵

The Partnership filed a lawsuit opposing the FPAA in the United States District Court for the Middle District of Florida and subsequently

246. *Id.*

247. *Id.* at *3.

248. *Id.*; see I.R.C. § 722 (2000).

249. *Brandon Ridge Partners*, 2007 WL 2209129, at *3; see Treas. Reg. § 1.722-1 (as amended in 2004). Although the issue was not discussed in the court’s opinion because it was not relevant to the summary judgment motion, Jefferson and the Partnership presumably intended to argue that Jefferson was not required to reduce his outside basis in the Partnership because the obligation to satisfy the short sale was a contingent liability.

250. I.R.C. § 6501(e)(1)(A) (2000 & Supp. V 2005).

251. *Brandon Ridge Partners*, 2007 WL 2209129, at *8.

252. *Id.* at *3; see I.R.C. § 362 (2000 & Supp. V 2005).

253. *Brandon Ridge Partners*, 2007 WL 2209129, at *3.

254. *Id.* at *4.

255. *Id.*

filed a motion for summary judgment, asserting that the proposed adjustment to its income was time-barred.²⁵⁶ Under § 6501(a)²⁵⁷ of the Code, the Service has three years from the date on which a partner's individual tax return is filed to assess a tax on that partner.²⁵⁸ However, § 6501(e)(1)(A) of the Code extends this three-year statute of limitations to six years if the partner "omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return."²⁵⁹ However, the Code further states:

In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.²⁶⁰

In this case, Jefferson filed his individual tax return for 1998 on October 5, 1999.²⁶¹ While the FPAA was not issued within six years of such date, a summons was issued prior to the FPAA that arguably tolled the six-year statute of limitations period. Therefore, both sides assumed for purposes of the summary judgment motion that the FPAA was issued outside of the three-year statute of limitations period but within the six-year statute of limitations period.²⁶² Based on § 6501(a), the Partnership claimed that the three-year statute of limitations barred the Service's FPAA. The Service responded that the six-year statute was applicable because the Partnership had omitted sufficient income from its return without providing adequate disclosure of such omission.²⁶³

The court denied the Partnership's summary judgment motion and held that under the assumption that the correct basis of the FES stock was zero, the six-year statute of limitations of § 6501(e)(1)(A) applied.²⁶⁴ The court first assessed whether the Partnership had omitted gross income in excess of twenty-five percent of the amount of gross

256. *Id.*

257. I.R.C. § 6501(a).

258. *Id.*

259. *Id.* § 6501(e)(1)(A).

260. *Id.* § 6501(e)(1)(A)(ii).

261. *Brandon Ridge Partners*, 2007 WL 2209129, at *2.

262. *Id.* at *4 n.7. The Partnership did not challenge the timeliness of the FPAA under the six-year statute of limitations. The Partnership conceivably could still raise this issue in the future, but the court's opinion does not provide enough facts to determine what the basis of such a challenge would be. *Id.*

263. *Id.* at *4.

264. *Id.* at *12.

income stated in the return.²⁶⁵ The Partnership reported the following information regarding the stock sale: “(1) the sales price was \$3,315,000; (2) the purported basis of the FES stock was \$3,283,958; and (3) the gain on the sale totaled \$31,042.”²⁶⁶ The Partnership argued that it did not omit gross income, even assuming the correct basis of the stock was zero, because “gross income” for these purposes meant gross receipts, which in this case was the \$3,315,000 earned on the stock sale, a figure which the Service did not dispute. The Partnership cited several cases that supported its argument that gross income meant gross receipts.²⁶⁷ The Service countered that, under the current version of the Code, gross income means gross receipts in the case of a sale of business goods and services, and thus the gross receipts test did not apply to the sale of the FES stock because the FES stock was not business goods and services.²⁶⁸ According to § 6501(e)(1)(A)(i), “[i]n the case of a trade or business, the term ‘gross income’ means the total of the amounts received or accrued from the sale of goods or services . . . prior to diminution by the cost of such sales or services.”²⁶⁹ The sale of the FES stock was not a sale of business goods and services, and thus the Service argued that an application of the gross receipts test to the sale of the FES stock “would render § 6501(e)(1)(A)(i) superfluous.”²⁷⁰ The court agreed with the Service and held that the Partnership omitted gross income from its return under § 6501(e)(1)(A).²⁷¹

Finally, the court determined that the Partnership did not adequately disclose the amounts omitted from gross income pursuant to § 6501(e)(1)(A)(ii).²⁷² The court agreed with the Partnership that for purposes of adequate disclosure, the court must consider not only the Partnership’s 1998 return but also the returns of Jefferson and the S Corporation because Jefferson’s return referred to his interests in both the Partnership and the S Corporation.²⁷³ However, the court determined that none of the three returns adequately disclosed that the proceeds of the short sale and the obligation to replace the borrowed treasury notes were contributed to the Partnership.²⁷⁴ The court also found that

265. *Id.* at *4.

266. *Id.*

267. *Id.*; *Bakersfield Energy Partners v. Comm’r*, 128 T.C. 207 (2007); *Grapevine Imps., Ltd. v. United States*, 77 Fed. Cl. 505 (2007); *Colony, Inc. v. Comm’r*, 357 U.S. 28 (1958).

268. *Brandon Ridge Partners*, 2007 WL 2209129, at *6.

269. I.R.C. § 6501(e)(1)(A)(i).

270. *Brandon Ridge Partners*, 2007 WL 2209129, at *6.

271. *See id.* at *8.

272. *Id.* at *11.

273. *Id.* at *9.

274. *Id.* at *12.

Jefferson did not reduce his basis in the Partnership by the value of the contributed obligation, and the returns did not disclose that either the basis of the FES stock was increased under § 754 or that the FES stock was the only investment asset held by the Partnership.²⁷⁵ The Court concluded:

As presented in the returns and statements attached thereto, the substance of the transactions relating to the sale of the FES stock (which included the contribution to the Partnership of the obligation to cover the short sale of the Treasury Notes and the effect on the Jefferson's [sic] basis in the Partnership) was not disclosed in a manner that was adequate to apprise the IRS of the true amount of capital gain that resulted from the sale of the FES stock.²⁷⁶

In concluding that the six-year statute of limitations applied, the court appeared to set a relatively high bar for the Partnership to clear to escape § 6501(e)(1)(A), and the blatant nature of the tax shelter transaction at issue may have played a role in the court's analysis.²⁷⁷

275. *Id.*

276. *Id.* at *11.

277. *Id.* at *12.