NORTH EAST JOURNAL OF LEGAL STUDIES

Volume Sixteen **Fall 2006**

NORTH EAST JOURNAL OF LEGAL STUDIES

An official publication of the North East Academy of Legal Studies in Business, Inc. © 2006
ISSN: 1545-0597

INFORMATION FOR CONTRIBUTORS

The *North East Journal of Legal Studies* is a double blind refereed journal, published once a year. Its purpose is to encourage scholarly research in legal studies and pedagogy related thereto.

Articles may be submitted simultaneously to this journal and others with the understanding that the author(s) will notify this journal if the article is to be published elsewhere. We will not publish an article that will be published in another journal.

Papers should relate to the field of Business Law (including recognized topics within Business Law and the Legal Environment of Business) or to Legal Studies Education.

The Journal will consider submission of articles from those papers presented at the North East Academy of Legal Studies in Business Annual Conference. The paper designated the recipient of the Hoehlein Award for Distinguished Paper at the NEALSB Conference will serve as the lead article of the journal. Up to four articles from resources other than those presented at the NEALSB Conference may be published in the journal.

Articles offered for inclusion in the next issue of the journal shall be submitted to the editor by September 1.

PROCEDURE FOR SUBMITTING PAPERS

Articles submitted for publication should be three clean, camera ready originals (no photocopies) accompanied by a diskette version in Microsoft Work for Windows prepared as set forth below and sent to:

Professor Sharlene A. McEvoy
Charles F. Dolan School of Business
Fairfield University
North Benson Road
Fairfield, CT 06824-5195

Submission must include a check for $50.00 payable to North East Academy of Legal Studies in Business. If the article is not published, $25.00 will be returned.

FORMAT

1. Papers should be no more than 20 single-spaced pages, including footnotes. Use font 12 pitch, Times New Roman. Skip lines between paragraphs and between section titles and paragraphs. Indent paragraphs 5 spaces. Right-hand justification is desirable, but not necessary.
2. Margins: left and right hand margins should be set at 1 ¼ inches, top margin at 1 ½ inches and bottom margin at 1 ¾ inches.
3. Page Setup: Custom size your paper to have a 6 3/4 inch width and a height of 10 inches. Your hard copy should be printed on a standard 8 1/2" x 11" paper size. This will allow for the proper binding and trimming for printing purposes.
4. Upon acceptance, the first page must have the following format: the title should be centered, in CAPITOL LETTERS. Two lines down center the word "by" and the author's name, followed by an asterisk(*). Begin text three lines under the author's name. Two inches from the bottom of the page, type a solid line 18 inches in length, beginning from the left margin. On the second line below, type the asterisk and the author's position of title and affiliation.
5. "Headings"
   FIRST LEVEL (caps, flush with left margin)
   Second Level (center, italics)
   Third Level (flush with left margin, italics, followed by a colon [:],
   Fourth Level (flush with left margin, italics, followed by a Colon [:], with text immediately following).
6. Endnotes should conform to Uniform System of Citation, 17th edition (2000), and should begin 3 lines after the end of the text.

7. An IBM compatible, 3 1/2 inch disc with the final version of your paper, in Microsoft Word, must accompany your paper.

Individual copies of the journal are available to non-members and libraries at $25.00 per copy. General correspondence, applications for membership in NEALSB or change of address notice should be addressed to the name above at the address therein stated.

NORTH EAST JOURNAL OF LEGAL STUDIES

VOLUME 16 **FALL 2006**

SPECIAL TAX ISSUE

OTHER ARTICLES

EMPLOYEE OR INDEPENDENT CONTRACTOR? CLASSIFICATION BY THE INTERNAL REVENUE SERVICE

by

Martin H. Zern*

I. BACKGROUND

A frequent and contentious issue existing between businesses and the Internal Revenue Service ("IRS") is the proper classification of persons hired to perform services. If the person hired is classified as an employee, numerous obligations are imposed on the business with respect to wages it pays: federal and, if applicable, state income taxes must be withheld; social security and Medicare tax must be withheld – and matched by the business; federal and state unemployment taxes must be paid; disability and workmen's compensation insurance have to be provided; and, the employee may have to be included in whatever fringe benefit packages that are provided by the business (e.g., medical and retirement benefits). These obligations imposed in an employer-employee relationship are applicable whether the employment is full or part time (although part-time personnel may get less or no fringe benefits). On the other hand, if the relationship to the business of the person it hires is that of an independent contractor ("IC"), the only obligation of the business is to issue

---

*Martin H. Zern, Esq., J.D., LL.M. (tax), C.P.A., Professor, Lubin School of Business, Pace University, New York

a statement (Form 1099-MISC) to the person hired setting forth the amount paid to the person, with a copy to the IRS.[1]

Where the facts and circumstances create an employer-employee relationship, rather than one of an IC relationship, the person hired is considered a common-law employee. Regulations issued by the IRS list numerous factors that must be considered and evaluated in determining whether someone hired to perform services is an employee or an IC.

If a person is an employee under common-law principles, the person has the status of an employee for federal tax purposes.[2] As such, obligations are imposed on the employer, as previously detailed. In this regard, it may be noted an officer of a corporation is considered an employee unless the officer does not perform any services or performs only minor services and neither receives any remuneration not is entitled to any; however, a director of a corporation in his or her capacity as such is not considered an employee.[3]

.

II. DETERMINING STATUS

A. In General

Under common law principles, as a broad general rule, an employer-employee relationship exists if the business for which services are performed has the right to control and direct the person performing the services not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished.[4]

Thus, an employee is someone subject to the will and control of the employer not only as to what shall be done but also as to how it shall be done. It is not necessary for the employer to actually direct and control the person as long as

the employer has the right to do so. The right to discharge is also an important factor indicating that a person is an employee. Other factors, such as the furnishing of tools and a place to work are also considerations. On the other hand, if a person is subject to the control and direction only as to the result, and not as to the means and methods of accomplishing the result, the person is an IC.[5]

Individuals such as physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in business in the pursuit of and independent trade, business, or profession, in which they offer services to the public, are considered ICs.[6]

Whether an employer-employee relationship exists under common law rules in doubtful cases will be determined based upon an examination of the particular facts of each case.[7] If the relationship exists, the designation of the relationship as something else, such as, partner, co-adventurer, agent, IC, or the like, is of no consequence.[8] All classes or grades of personnel are included in the employer-employee relationship, including superintendents, managers and other supervisory employees, and specifically corporate officers, as previously noted.[9]

B. Partners

A person who is legitimately a partner in a partnership is not considered an employee.[10] Whether someone is a true partner for federal tax purposes, however, depends upon the specific facts and circumstances, taking into consideration applicable state law defining a partnership relationship. The IRS, however, is not bound by a determination under state law provisions and may nevertheless conclude that an employer-

employee relationship exists despite a determination of partnership status under state law principles.

C. Relevant Factors

In determining whether an employer-employee relationship exists, the IRS for some time utilized a so-called *20*-factor analysis.[11] However, since 1996 the IRS has changed its focus to considering all information that provides evidence of the degree of control and the degree of independence. Accordingly, the 20-factor analysis is no longer as germane. Under the new analytic regime, evidence to be considered in determining whether an employer-employee relationship exists falls into three categories: behavioral control, financial control, and the type of relationship of the parties.[12]

1. Behavioral Control:

Factors showing that a business has the right to control how a worker does the task the worker was hired to perform include the degree of instructions that are given to the worker. Overall, the instructions to consider are about when, where and how to work. The following are examples of the type of instructions that, if present, would indicate an employer-employee relationship:

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual
- What order or sequence to follow.

It is recognized that the amount of instruction can vary from job to job. The IRS realizes, however, that even if no instructions are given, there may be sufficient behavioral control if the party hiring has the right to control how the work results are achieved. For example, a business hiring a worker may not have the expertise to instruct in a highly specialized area; in some cases, no instruction may be necessary. The key consideration is whether the business hiring has retained the right to control the details of a worker's performance, or has given up that right. An important factor is training. Employees generally are trained to perform in a certain way whereas ICs ordinarily use their own methods.[13]

2. Financial Control:

The right to control the business aspects of the worker's job is indicative of an employer-employee relationship. Factors showing financial control include:

- *Unreimbursed business expenses*. An IC is more likely to have unreimbursed business expenses than an employee, although an employee may also have such expenses. Fixed ongoing costs are also indicative of an IC.
- *Worker's investment*. Generally, an IC has a significant investment in facilities he or she uses and in tools and equipment, although it is recognized that this is not always the case.
- *Relevant market*. An IC generally offers services to the public and is free to seek out business opportunities in the relevant market. Moreover, an IC often advertises and maintains a visible business location.
- *Payment*. Employees generally are paid a regular wage based upon an hourly, weekly, or other period of time.

Such payment is indicative of employee status even though wages are supplemented with commissions. In contrast, an IC usually gets a flat fee, although some professions, notably law and accounting, commonly bill for services based upon hours worked.

- *Profit or loss*. An IC can make a profit or suffer a loss[14]

3. Relationship:

The relationship between parties is also a factor in determining whether an employer-employee relationship exists. The nature of the relationship between the parties may be determined by:

- A written contract describing the relationship between the parties.
- Whether a worker is provided with fringe benefits that are commonly given to employees (e.g., medical and retirement benefits).
- The permanency of the relationship. If the relationship is open ended, this generally is indicative of an employee. In contrast, an IC is hired to perform a task that is expected to be completed within a specific time period, or to complete a specific project.
- The extent that the services are a key aspect of the business. A worker that provides essential and continuous services is more likely to be subject to the direction and control of his or her activities, indicating an employer-employee relationship.[15]

D. Industry Examples

For further taxpayer guidance, the IRS has set forth examples by certain industry classifications.[16] The examples are probably taken from those industries where misclassification is a common practice, as gleaned by IRS audits or from other sources.

1. Building and Construction Industry:

- Example 1. This example involves a person hired to supervise the remodeling of a house. The owner of the home advances no funds, buys all the necessary supplies, carries liability and worker's compensation insurance on the person hired and others hired to assist them, pays an hourly rate and constantly oversees their work. The supervisor hired may not transfer the assistants to other jobs and may not work on other jobs until the current job is completed. He assumes no responsibility to complete the work and has no contractual liability if he doesn't. Conclusion: The person hired and his assistants are employees.

- Example 2. This example involves an experienced tile setter hired orally by a corporation to render services at various job sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation provides all the materials and makes frequent inspections of his work and pays him on a piecemeal basis. The corporation also provides worker's compensation. The worker does not have a place of business or holds himself out as available to others.

Either party can terminate the relationship at any time. Conclusion: The tile setter is an employee.

- Example 3. In this case, an individual is hired by a corporation to provide construction labor to build a group of houses. The company agrees to pay all construction costs, but the individual supplies all tools and equipment. He personally performs services as a carpenter and mechanic getting an hourly wage. He also acts as a foreman and engages others to help him. The company has the right to hire or discharge any helper. A company executive frequently inspects the construction site. When a house is finished, the individual is paid a certain percentage of its costs. He is not responsible for defects or waste. At the end of the week, he presents the company with a statement of what he has spent, including the payroll. With the check he gets, he pays his assistants (and presumably himself), although he is not personally liable for their wages of the assistants. Conclusion: The individual and his assistants are employees.

- Example 4. In this situation, an individual is employed by a corporation to complete roofing on a housing project. Pursuant to a signed contract the individual is to get a flat amount for services rendered. The individual is a licensed roofer and carries worker's compensation and liability under his business name. He hires his own roofers and treats them as employees for federal unemployment tax purposes. If there is a problem with the roofing, the individual is responsible. Conclusion: An IC.

- Example 5. The final example involves an electrician who submitted a bid for electrical work based upon a

> fixed number of hours the job is expected to take and a specified rate per hour. Thus, the amount the electrician ultimately gets is fixed by multiplying the fixed number of hours by the rate. A fixed payment is to be made every other week for 10 weeks. This is not considered payment by the hour even if more or less than the set number of hours is worked. Additionally, the electrician contracts with other companies and advertises. Conclusion: An IC.

2. Trucking Industry:

Here, only one example is given.

An individual operating a trucking company contracts with a corporation to deliver material at a certain amount per ton. He is not paid for any articles not delivered. He may lease other trucks and engage other drivers to complete the contract. The individual pays all operating expenses, including insurance coverage. He owns all the equipment or rents it, and he is responsible for all maintenance. The corporation provides none of the drivers. Conclusion: An IC.

3. Computer Industry:

The computer industry has been notorious for laying people off and then hiring them back purportedly as ICs. Again, only one example is given.

A computer programmer is laid off due to downsizing. He is hired back under a contract that will pay him a flat amount to complete a one-time project to develop a certain product, but it is not clear how long it will take to complete it. Accordingly, he is not guaranteed any minimum amount for the time he spends. He gets no instructions beyond the specifications for

the project. His contract categorizes him as an IC and that he is to receive no benefits from the corporation. The corporation issues the programmer a 1099-MISC. The programmer works on his own computer at his home and is not expected to attend corporate meetings. Conclusion: An IC.

This example is troubling. Quite often people laid off are hired back for a project, work on it full time, and then are assigned to another project and then another on a continuous full-time basis for an extended time period. The author of this article is familiar with a situation where a programmer worked exclusively for a company for about two years purportedly as an IC. It would seem that at a certain point, the person should be considered an employee even where the work is done at home, which is clearly feasible for computer programmers.

4. Automobile Industry:

- Example 1: This example involves the typical car salesperson. She works six days a week and is required to be in the showroom during times assigned by the dealership. She appraises trade-ins, subject to approval by a manager, develops leads and reports results to a manager. She is experienced and need minimal assistance in closing and financing sales. Her compensation is commission based and she is provided health insurance and group-term life insurance. Conclusion: An employee.

- Example 2: An individual is a mechanic at an auto dealership. He works regular hours and is paid on a percentage basis of the repair cost. He has no investment in the repair department. He is provided with the facilities, parts and supplies. He determines the amount to be charged for the repair, parts to be used

and the time to complete the job. He checks all estimates and repair orders. Conclusion: An employee.

- Example 3: In this case, a person does auto body repairs in space furnished by an auto dealership. He provides his own tools, equipment and supplies. He does all the bodywork coming into the dealership, but seeks out bodywork from insurance adjusters and others. He hires his own helpers, determines his own and his helpers hours, quotes prices for repair work, makes all adjustments and assumes all bad debts. His compensation is a large percentage of the gross collections from the body shop. Conclusion: An IC.

5. Taxicab Driver:

An individual rents a cab from a taxi company for a fixed amount per day. He pays the cost of maintaining and operating the cab and keeps all fares. He utilizes the cab company's two way radio communication equipment and dispatcher, and benefits from advertising by the taxi company. Conclusion: An IC.

6. Salesperson:

Apparently due to the myriad situations involving salespersons, no specific examples are given. Accordingly, each case stands alone and common-law principles must be applied in determining whether salespersons are employees.[17]

Even if a salesperson is not an employee under common-law principles, his or her pay may still be subject to social security, Medicare, and federal unemployment taxes. Such a salesperson is classified as a statutory

employee. A person is deemed to be a statutory employee if all eight elements of the statutory employee test are met:

1. Works full time for one person or company, except for sideline sales activities for others.

2. Turns over all sales orders to the company for which she or he works.

3. Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments.

4. Sells merchandise for resale or use by the customer.

5. Does substantially all the above work personally.

6. Has no substantial investment in the facilities used to do the work, other than for a transportation facility, such as an automobile..

7. Maintains a continuing relationship with the person or company for which he or she works.

8. Is not an employee under common law rules.[18]

III. STATUTORY EMPLOYEES

For purposes of social security and Medicare provisions only, there are four categories of persons classified as statutory employees,[19] and for two of the categories federal unemployment tax is applicable.[20] Thus, for a statutory employee, no withholding of income tax is required. The four categories of employees for whom social security and Medicare are applicable are those who perform services for remuneration as:

- An agent-driver or commission-driver engaged in distributing meat, vegetable, fruit or bakery products, beverages (other than milk), or laundry or dry cleaning services for a principal;
- A full time life insurance salesman;
- A home worker performing work, according to specifications furnished by the person for whom services are performed, on materials or goods furnished by such person, which are required to be returned to such person or someone designated by him;
- A traveling salesperson, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his or her principal of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments for merchandise for resale or supplies for use in their business.

With respect to all four categories, the contract of service must contemplate that substantially all of the services are to be performed personally by such individual. However, an individual will not be considered a statutory employee under these provisions if the person has a substantial investment in facilities used in connection with the performance of such services (other than transportation facilities), or if the services are in the nature of single transaction not part of a continuing relationship with the person for whom the services are performed.[21]

A person can be a statutory employee only if the person is not otherwise a common law employee. Statutory employees may deduct expenses in arriving at adjusted gross income and therefore are not subject to the 2% reduction applicable when employee expenses are itemized.[22] The regulations under the

applicable code section go into considerable further detail concerning whether a person qualifies as a statutory employee.[23] Compensation paid to a statutory employee is subject to federal unemployment tax except for a life insurance salesman and a home worker.[24]

IV. STATUTORY NON-EMPLOYEES

A person performing services as a qualified real estate agent or direct seller is not considered an employee and the business hiring such person is not considered an employer.[25]

A person is a "qualified real estate agent" if the person is licensed, substantially all of his or her remuneration is based on sales, and the services are performed pursuant to a written contract providing that the person will not be treated as an employee for federal tax purposes.[26]

A person is a "direct seller" if the person is engaged in the business of selling consumer products to a buyer on a buy-sell or deposit-commission basis, or any similar basis, for resale in the home or at a place of business other than in a permanent establishment, including someone engaged in the business of delivering or distribution of newspapers or shopping news. Here too, all of the remuneration must be based upon sales and the services must be provided pursuant to a written contract providing the person will not be considered an employee for federal tax purposes.[27]

V. EFFECT OF MISCLASSIFICATION

Classifying a person as an IC when there is no reasonable basis for doing so results in the business being liable for employment taxes for the worker.[28] Additionally, the "responsible persons" within a business organization who fail

to collect, truthfully account for and pay over tax withheld to the government, in addition to any other penalties provided by law, are liable for a penalty equal to the total amount of tax not collected, or not accounted for and paid over.[29] This penalty is sometimes referred to as the 100% penalty. Moreover, it cannot be discharged in bankruptcy.[30]

VI. RELIEF PROVISION

The classification of a person as an IC who properly should have been classified as an employee, can be very costly to a business, possibly resulting in its demise, the continuing liability of the owners of the business for withheld taxes and, as indicated, no relief possible under the bankruptcy laws.

In 1978, Congress enacted a relief provision as part of the Revenue Act of 1978, specifically Section 530 of the Act, to foster settlements in contentious cases, and perhaps to avoid the downfall of businesses assessed a large claim for taxes that should have been withheld, and consequent penalties.[31]

The relief provision provides that if a business never treated an individual as an employee, and for all periods after 1978 all federal tax returns that were required to be filed for the individual were filed as if the person were a non-employee, then the individual for that period will not be deemed to be an employee, unless there was no reasonable basis for treating the person as a non-employee. In essence, this means that the individual was never treated as an employee by the business and that the appropriate information returns (i.e., Form 1099-MISC) were consistently filed with the IRS for the individual. Relief is not allowed, however, if the Form 1099-MISC is filed after the IRS questioned the individual's status on an audit.[32] If taxes were withheld for the individual, whether or not remitted to the IRS, such withholding would result in the person being

classified as an employee.[33] Furthermore, relief is possible only if the business treated individuals in similar positions consistently. After 1996, the IRS was required to give notice of the relief provision at the onset of any worker reclassification audit.[34]

The key to obtaining relief, however, and a tough hurdle to leap, is the requirement that there be a reasonable basis for classification as an IC. Based on case law, one possibility is for the business to show that the misclassification as an IC was based upon the advice of an attorney.[35] Although the cases providing relief under Section 530 involved advice by an attorney, the IRS has stated that a reasonable basis would exist where the business relied upon the advice of an attorney or accountant who knew the facts about the business.[36]

VII. REASONABLE BASIS SAFE HAVEN RULES

In a Revenue Procedure issued in 1985, the IRS set forth several safe haven alternative standards for determining whether a taxpayer has a reasonable basis for not treating an individual as an employee.[37] Reasonable reliance on any one of the safe havens is sufficient to uphold classification as an IC:

A. Precedent.

Judicial precedent or published rulings (whether or not related to the particular business of the taxpayer), technical advice or a determination letter pertaining to the taxpayer.

B. Prior Audit.

A past IRS audit (whether or not related to employment tax issues) where no assessment was made for treating persons as

ICs provided such persons held similar positions to the persons whose status is at issue.

C. Industry Practice.

Long-standing industry practice of a significant segment of the industry in which the individual whose status is at issue is engaged. The benchmark for a significant segment of the industry is 25%, but may be less depending on the facts and circumstances. A practice will be considered of long-standing if it has continued for at lease ten years, but again may be less depending on the facts and circumstances.[38]

A taxpayer who fails to meet any one of the three save havens may nevertheless be entitled to relief if the taxpayer can demonstrate, in some reasonable manner, a reasonable basis for not treating the individual as an employee. According to a Congressional report, the term "reasonable basis" is to be construed liberally in favor of the taxpayer.[39] It is important to recognize that the safe haven provisions are applicable only if the business did not treat the individual whose status is at issue as an employee by withholding tax or otherwise filing employment tax returns with respect to the individual.
Moreover, relief under Section 530 does not change in any way the status, liabilities, and rights of the worker whose status is at issue. The liability of the employer for employment taxes is terminated, but the worker is not converted from the status of employee to IC. Relief of an employer from liability under Section 530 also relieves any responsible person from personal liability.[40]

Since in many, and perhaps most, cases there is no applicable precedent or prior audit, the only safe haven that is germane is the demonstration to the IRS of a long-standing industry practice of a significant segment of the industry. As a

practical matter, it would seem difficult for a business to prove a long-standing industry practice by making inquiries of other companies. Clearly, any company treating a worker as an IC and not an employee in a doubtful situation would be loathe to admit to such treatment or to provide any relevant information for fear of being audited itself by the IRS. Accordingly, the possibility of demonstrating an industry practice by obtaining information from companies similar to one's own would seem quite limited. However, although it is generally up to the taxpayer to prove what it is asserting, there is a chance that the IRS will investigate whether there is a long-standing industry practice. In one situation, the taxpayer submitted the names of twenty competitor firms in Manhattan that purportedly treated similarly situated workers as ICs. The IRS itself conducted a survey of the 20 firms in order to see if there was in fact a long-standing industry practice. Although the survey showed that there was no long-standing industry practice, the point is that it was the IRS that conducted the survey. Obviously, the businesses named had no choice but to respond to the IRS inquiries, whereas inquiries by the business being audited would probably have been disregarded.[41]

In summary, if a business has consistently treated an individual as an IC along with others in similar positions, although erroneously, the business will be relieved of liability for payroll taxes if there is a reasonable basis for treating that individual as a non-employee and Form 1099-MISC has been filed for the individual. And, as noted, any responsible person will escape personal liability.

VIII. CLASSIFICATION SETTLEMENT PROGRAM

Whether a worker should be classified as an IC or employee is a difficult issue for many businesses, as well as for the IRS. In fact, for many years, the IRS was prohibited from issuing any guidance regarding employment tax status. Businesses had long complained about the uncertain results of the worker classification standards, which essentially were a facts-and-circumstances test, as required by law.[42] The uncertainty apparently was also of great concern to the IRS since it sometimes conceded the applicability of Section 530 in close cases, where there were mixed precedents, because of litigating hazards.[43]

In an attempt to make it easier for businesses and the IRS to reach agreement when the worker classification issue is raised, the IRS initiated a Classification Settlement Program ("CSP") that established standard settlement agreements in worker classification cases, and allowed businesses and tax examiners to resolve worker classification cases as early as possible in the administrative process.[44]

Under the CSP, IRS examiners can offer a business under audit a worker classification settlement agreement using a standard closing agreement. Generally, under such a closing agreement, a business that has filed Form 1099-MISC information returns for all similarly situated workers but failed to meet any other requirements for relief under Section 530 (i.e. failed to show a reasonable basis for the classification) could reclassify its workers prospectively and pay only a specified tax assessment not exceeding one year's liability. If applicable, the CSP offers a strong incentive to settle since the classification issue often involves more than one year. The exact amount of the assessment would depend on the extent to which the business satisfied the other requirements of Section

530 (i.e. reasonable basis requirement). Participation by a business in the CSP is strictly voluntary. A business declining to accept a settlement offer would retain all appeal rights.[45]

Although the CSP is clearly beneficial to a business where a worker classification issue is on the fence, it also provides the IRS with another option. Prior to initiating the CSP, the IRS was often faced with the prospect of either conceding complete relief under Section 530 or litigating whether the section is applicable, with all the hazards and time and expense of litigation. The CSP gives the IRS another way to collect some tax in a disputed case, though limited to one year.[46]

To summarize, if the business has been consistent in treating similarly situated workers as ICs and has filed Form 1099-MISC for each such worker, then Section 530 is applicable and an assessment for only one year is possible. Moreover, the assessment can be limited to 25% of the one-year assessment if the business can further present a colorable argument that it satisfies the reasonable basis test. Of course, if the taxpayer can show that it meets all three tests (i.e., employee consistency, reporting consistency and reasonable basis), complete relief under Section 530 is available. Accordingly, the 25% solution seems applicable where both the IRS and the taxpayer are uncertain as to whether there was a reasonable basis for the classification. For example, the taxpayer may show that some similar businesses treat workers as ICs but others do not. Or, perhaps the taxpayer alleges that it relied on the written advice of an attorney, but the advice turns out to be somewhat ambiguous. Thus, the 25% solution seems to be the final compromise obtainable from the IRS by a taxpayer where it is a close call as to whether there was a reasonable basis for the classification. It should be obvious, however, that the IRS will not settle for 25% of one year's liability unless it believed that its case was problematic.

If the business settles under the CSP and pays the one-year assessment, it will be entitled to a deduction for such payment since it effectively will constitute additional wages. Accordingly, the impact of the one year assessment is somewhat ameliorated. If the business is operating as an S Corporation, the benefit of the deduction will flow through to the shareholders. However, an IRS agent advised the author of this article that a condition of the 25% settlement would be no corresponding deduction.

IX . CONCLUSION

The issue of whether a worker is an employee or an IC is of particular concern when a business hires freelancers or consultants. In addition to significant tax exposure where there is a misclassification – possibly causing the demise of the business – there might be exposure to a costly lawsuit brought by the workers erroneously classified as ICs.

Microsoft faced just such a problem when it hired what it considered freelancers in addition to its regular employees. The freelancers received cash compensation but no fringe benefits. They were hired for a variety of specific projects and all signed agreements acknowledging that they were ICs. They did not participate in any employee benefit plans and Microsoft did not pay any federal employment taxes or withhold income tax for them.

The problem for Microsoft was that it did not treat these workers as ICs. Instead, the freelancers were integrated into the regular workforce often working on teams with full- time employees and performing the same functions. They had to work on site and received all of their equipment and supplies from Microsoft. This treatment got Microsoft in trouble with

the IRS back in 1989 and 1990. Ultimately, Microsoft agreed with the IRS to treat the workers as employees for purposes of tax withholding and any other federal tax obligations paying all back taxes owed.

This, however, was not the end of the story. The affected workers demanded full employee benefits for the time they were classified as ICs. This included, among other things, coverage in the company's 401(k) plan and a discount stock purchase plan, both of immense value. When Microsoft refused, the workers file suit in federal court. Although the district court dismissed the suit, on appeal the Ninth Circuit held for the workers.[47] Subsequently, a 15-judge panel of the Ninth Circuit reheard the case. Their decision largely affirmed the prior decision of the appellate court.[48]

A lesson to be gleaned from the Microsoft case is that simply having a worker sign an agreement that he or she is an IC is not determinative of the worker's status. The determination as to status will be based on the law not self-serving documents. The tax penalties for misclassification are severe although possibly now ameliorated by the CSP. Perhaps of equal if not more important consideration is that a misclassification will be even more expensive if the business has generous fringe benefits such as Microsoft. Whether contingent workers can be excluded from fringe benefit plans is problematical.

Firms and workers can request a determination of status by filing Form SS-8 ("Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding"). This is a quite lengthy form that asks for a lot of information and asks numerous questions. It is noteworthy that a worker can file the form. Accordingly, a worker who feels that he or she is really an employee and not an

independent contractor can complain to the IRS by filing the form. If the worker is truly disgruntled, he or she can also complain to the state unemployment and worker's compensation agencies. Of course, this may result in loss of employment unless the worker has already been let go or has left.

No doubt there are many in business that knowingly misclassify workers in order to save money taking a chance that they can get away with it. One should think twice, however, since, as this paper explains, the consequences if caught can be disastrous.

ENDNOTES

[1] Any person engaged in a trade or business for whom services are provided by a non-employee is required to provide a statement to the service provider, with a copy filed with the IRS if, in connection with its trade or business, it pays an amount to such person totaling $600 or more within the taxable year, specifically, Form 1099-MISC, Miscellaneous Income (IRC §6041A). There is a whole series of Forms 1099 covering various types of payments (e.g., interest: Form 1099-INT; dividends: Form 1099-DIV; and, pension payments: Form 1099-R.) I.R.C, §6041, Reg. §1.6041, I.R.C. §6042.
[2] I.R.C. §3121(d)(2).
[3] I.R.C. §3121(d)(1).
[4] Reg. §31.3121(d)-1(c)(2)
[5] *Id*. The common law rules for determining whether an employer-employee relationship exists are contained pretty much word-for-word in the regulations relating to social security and Medicare taxes (Reg. §31.3121(d)-1(c)), the regulations relating to federal unemployment tax (Reg. §31.3306(i)-1(b)), and the regulations relating to withholding of income tax (Reg. §31.3401(c)-1(b)).
[6] *Id*.
[7] Reg. §31.3121(d)-1(c)(3).
[8] Reg. §31.3401(c)-1(e).
[9] Reg. §31.3401(c)-1(f).
[10] Rev. Rul. 69-184, 1969-1 C.B. 256.

[11] In Rev. Rul. 87-41, 1987-1, C.B. 296, the IRS set forth the 20 factors to consider in determining whether someone is an employee or IC. Many of the factors are incorporated in the revised analysis.
[12] IRS Training Manual 3320-102 (October 1966), IRS Publication 15A.
[13] IRS Publication 15A.
[14] *Id*.
[15] *Id*.
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] I.R.C. §3121(d)(3).
[20] I.R.C. §3306(i).
[21] I.R.C. §3121(d)(3).
[22] Rev. Rul. 90-93, 1990-2 C.B. 33.
[23] *See* Reg. §31.3121(d)-1(d).
[24] I.R.C. §3306(i).
[25] I.R.C. §3508.
[26] I.R.C. §3508(b)(1).
[27] I.R.C. §3508(b)(2).
[28] I.R.C. §3509.
[29] I.R.C. §6672. There is a substantial body of case law dealing with whether a person is a "responsible person," the result depending upon the particular facts and circumstances.
[30] 11 U.S.C. 507(a)(8)(C).
[31] Section 530 of the Revenue Act of 1978. This provision was not codified as part of the Internal Revenue Code.
[32] Rev. Rul. 81-224, 1981-2 C.B. 197.
[33] Rev. Proc. 85-18, 1985-1 C.B. 518, Section 3.03.
[34] The Small Business Job Protection Act of 1996, Pub. L. 104-188, Section 1122.
[35] Select Rehab, Inc. v. United States, 205 F. Supp. 2d 376 (M.D. Pa. 2002); North Louisiana Rehabilitation Center, Inc. v. United States, 179 F. Supp. 2d 658 (W.D. La. 2001).
[36] Publication 1976 (9-96).
[37] Rev. Proc. 85-18, 1985-1 C.B. 518.
[38] The Small Business Job Protection Act of 1996, Pub. L. 104-188, Section 1122.
[39] H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633.
[40] Rev. Proc. 85-18, 1985-1 C.B. 518, Section 3.07.
[41] *See* 1997 Field Service Advice (FSA) LEXIS 492.

[42] I.R.C. §3121(d)(2).
[43] *See* 1998 FSA LEXIS 375.
[44] 1996 IRB LEXIS 76; IR 96-7. The IRS implemented the CSP on a two-year trial basis in 1996. Review of the program and feedback from the public indicated that the program was successful in facilitating early resolution of cases. Accordingly, the IRS extended the CSP indefinitely (Notice 98-21; 1998 IRB LEXIS 152).
[45] The CSP establishes administrative appeal rights even while an examination of other issues is in progress. For appeal rights to the United States Tax Court, *see* I.R.C. §7436 and Notice 2002-5, 2002 IRB LEXIS 25.
[46] *See* 1997 FSA LEXIS 492.
[47] Vizcaino v. Microsoft Corp., 97 F.3d 1187 (9th Cir. 1996).
[48] Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997).

THE DEDUCTIBILITY OF EDUCATION EXPENSES: OCCUPATIONAL HAZARD?

by

Kathleen M. Weiden* and Helen F. Tomasko**

INTRODUCTION

In his book, *The Wealth of Nations,* Adam Smith identifies four canons of taxation, by which to evaluate a tax system.[1] These canons are: equality, convenience, economy and certainty. Equality means that a taxpayer is treated fairly and equitably by the payment of taxes in proportion to his or her income level. Convenience represents simplicity in administration of the tax system, which impacts compliance. Economy refers to the collection of tax revenue in the most cost efficient manner possible. Certainty means the ability of taxpayers to predict the effect of the tax structure on their affairs.

Beyond paying taxes in proportion to one's income, equality should also imply that taxpayers in similar situations should receive the same treatment under the tax laws. This paper addresses the issue of equality *in practice* by examining the record of judicial and administrative decisions, with respect to the deductibility of education expenses under §162 of the Internal Revenue Code ("I.R.C."), across various occupations.

---

* Assistant Professor of Taxation at Fairfield University. B.S. from Manhattan College, a M.S., Taxation from Pace University and a Ph.D. from Baruch College of the City University of New York. Dr. Weiden is also a CPA (New York).
** Candidate for a MBA with Taxation Concentration at Fairfield University. B.S. in Sociology from Dunbarton College of Holy Cross and is an Enrolled Agent.

This examination is motivated by the United State Tax Court ("Tax Court") analysis and holding in an August, 2004 case, *Will M. McEuen III, et ux. v. Commissioner* [2] on the deductibility of education expenses under I.R.C. §162. In disallowing the taxpayer's expenditures for a Masters of Business Administration degree ("MBA"), the court concluded that the taxpayer's educational expenditures were incurred to meet the minimum educational requirements for the position of an associate in an investment banking firm, and therefore, were investments in personal capital, and were non-deductible. In reaching this conclusion, the court held that the three year position of analyst (the position from which one could be promoted to associate) was a "subordinate temporary position", and therefore analysts were not yet engaged in the trade or business of investment banking, despite being employed by an investment banking firm. In addition, the court held that the change in the taxpayer's potential scope of duties, as a result of additional education, qualified her for a new trade or business, which also made the education costs nondeductible.

The Tax Court's conclusion that the position of analyst was a "subordinate temporary position" to the "permanent career position" of associate raises the following questions. Across occupations, when are more specialized and/or responsible positions considered a different trade or business than positions less specialized and/or responsible? Is there a basis for taxpayers to argue that the holdings and/or decisions in this area have resulted in less than equitable treatment across the various occupations under the tax law?

This paper examines the record of judicial and administrative decisions on the deductibility of education expenses under § 162, for tax years after 1967, when the regulations for I.R.C. § 162 were last amended. The paper considers only decisions where the taxpayer is employed in a trade or business, in a general sense, prior to incurring

education costs. Decisions involving a taxpayer obtaining a bachelor's degree, the teaching profession or foreign nationals are not considered.

This paper first discusses I.R.C. §162 and the relevant regulations. Prior judicial and administrative decisions across a variety of occupations are then summarized, followed by an analysis of the decisions as they have been applied across occupations. The conclusion discusses the implications of, and questions raised by, this study. It appears that more questions are raised than answered.

AUTHORITY FOR THE DEDUCTIBILITY OF EDUCATION EXPENSES

The authority for the deduction of education expenses is established in I.R.C. §162(a), which allows for the deduction of "ordinary and necessary trade or business expenses paid or incurred during the tax year in carrying on a trade or business." Although I.R.C. §162(a) provides several examples of expenses that qualify for deductibility, it does not provide an exhaustive list of qualifying expenses. The Regulations under I.R.C. §162 are more specific, however, and address a variety of expenses, including travel, repairs and rentals. Reg. §1.162-5 addresses expenses for education.

For purposes of this article, the first three paragraphs of Reg. §1.162-5 are relevant. Reg. §1.162-5(a) identifies the general types of educational expenditures that are deductible, Reg. §1.162-5(b) identifies the general types of educational expenditures that are not deductible, and Reg. §1.162-5(c) elaborates on the characteristics of deductible educational expenditures.

Reg. §1.162-5(a) indicates that expenditures made by an individual for education are deductible, as ordinary and necessary business expenses, " . . . if the education (1)

maintains or improves skills required by the individual in his employment or other trade or business, or (2) meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation." Under Reg. §1.162-5(c)(1), refresher courses, courses dealing with current developments, and academic and/or vocational courses are deemed to be education that maintains or improve skills required in an individual's employment or other trade or business. Under Reg. §1.162-5(c)(2), education meets the express requirements of the individual's employer or the applicable law or regulation, imposed as a condition of employment retention, status or rate of compensation, when there is a bona fide business purpose for the employer to impose such requirements.

Reg. §1.162-5(b)(1) indicates that when educational expenditures constitute an investment in the taxpayer's personal capital, such expenditures are not deductible. Under Reg. §1.162-5(b)(2)(i), a taxpayer's expenditures, for an education that meets the minimum educational requirements for qualification in his/her employment or other trade or business, are investments in the taxpayer's personal capital, and are therefore, nondeductible. The employer's requirements, applicable law and regulations, as well as standards of the profession, trade or business involved are all factors in determining the minimum education required to qualify for a position or other trade or business. In addition, the fact that a taxpayer is rendering services in a particular employment status suggests that the taxpayer has already met the minimum education requirements. Under Reg. §1.162-5(b)(3), educational expenditures that qualify the taxpayer for a new trade or business are also considered investments in the taxpayer's personal capital, and are therefore, nondeductible.

This regulation further indicates that a change of duties will not constitute a new trade or business if the new duties involve the same general type of work performed in the taxpayer's current position.

As a final consideration, both Reg. §§1.162-5(c) and 1.162-5(b)(1) contain the same caveat. If the education fulfills the minimum employment requirements for the taxpayer or qualifies the taxpayer for a new trade or business, such expenditures will be treated as investments in personal capital, and therefore, nondeductible. Thus, in order to successfully deduct educational expenditures under I.R.C. § 162, taxpayers must not only demonstrate that the educational expenditures meet the definition of deductible educational expenditures; they must also show that those same expenditures do not constitute investments in personal capital.

DETERMINATION OF THE TRADE OR BUSINESS BOUNDARIES OF CERTAIN OCCUPATIONS

Almost without exception, the decisions in this area begin with the question of whether the occupation-related education costs meet the standards for non-deductibility under Reg. § 1.162-5(b), rather than whether they meet the standards for deductibility under Reg. § 1.162-5(a). A determination that educational expenses are non-deductible renders moot the question of whether the education expenses are deductible. The majority of the decisions have focused on the standards for non-deductibility provided in Reg. §1.162-5(b)(3), rather than those provided in
Reg. §1.162-5(b)(2).

Reg. §1.162-5(b)(3) indicates that a change in duties resulting from further education will not constitute a new trade or business if the new duties reflect similar responsibilities prior to the education. The courts and the IRS use a

commonsense approach to determine whether the taxpayer has entered a new trade or business.[3] Typically, this means that a comparison is made of the taxpayer's duties before the education versus the taxpayer's duties after the education so as to establish lines of demarcation between trades or businesses. In making this comparison, the courts and/or the IRS have often relied upon the duties described and permitted under state licensure law and/or professional certification standards for the particular occupation ("external determinants of duties"). In those occupations without applicable state licensure law or professional certification standards, the courts and/or the IRS have relied upon the taxpayer's or the employer's own delineation or description of duties for the particular occupation ("internal determinants of duties").

External Determinants of Duties

Occupations with Licensure:

Despite the fact that the taxpayer was already engaged, either completely or to a large extent, in a particular field, the courts generally conclude that moving from unlicensed status to licensed status in the same field is moving from an existing trade or business to a new trade or business for purposes of Reg. §1.162-5(b)(3). This reflects the perception that an unlicensed taxpayer cannot be performing the same general duties as a licensed taxpayer, despite being in the same field.

Thus, unlicensed accountants have been denied deductions for courses required to qualify as a Certified Public Accountant [4] ("CPA") and for review courses to prepare for the CPA exam[5]. A landscape architect was denied a deduction for education to qualify him to sit for the Registered Landscape Architect exam in Massachusetts[6]. A law librarian was denied the costs of law school[7], as were patent examiners.[8]

The courts have also generally viewed a taxpayer moving from one license to another as moving from an existing trade or business to a new trade or business. These decisions reflect the notion that changing licenses means changing fields, and it is not reasonable to assert that the general duties can be the same for purposes of Reg. §1.162-5(b)(3) when two different fields are involved.

A CPA engaged in taxation and business planning was denied deductions for costs of law school[9], a licensed practical nurse was denied deductions for costs of education to become a physician's assistant[10], an attorney was denied deductions for education costs to become a real estate broker[11], and a nurse was denied deductions for costs of a degree program in biology, a prerequisite for entrance into medical school.[12]

One decision involves two licenses in the same field. In *Charles A. Robinson*[13], the taxpayer, a licensed practical nurse ("LPN"), deducted the costs incurred in pursuing a program that would entitle her to sit for the registered nurse ("RN") examination in Minnesota. The taxpayer argued that the education maintained or improved her skills in the trade or business of nursing. The court first reviewed the Minnesota nursing statutes, which licenses both practical nursing and registered nursing. The court concluded that the state's separate licensing of practical and registered nursing was evidence that Minnesota ". . . envisions a very definite qualitative difference between a RN and a LPN." The court indicated that while the statute identifies some duties as being identical, RNs possessed certain additional powers that LPNs did not, such as delegating nursing functions to other nursing personnel. It should be noted that the court also reviewed the job descriptions of the positions of LPN and RN at the hospital where the taxpayer worked part-time during her education, and concluded that the hospital-employer also viewed an LPN and a RN as two different trades or businesses. This decision

reflects the notion that the two licenses in the same field must be two different trades or business because the state regulations specify two distinct sets of duties.

Occupations with Licensure and Professional Certification:

In Rev. Rul. 74-78[14], the IRS ruled that a dentist engaged in the full time practice of general dentistry, who returned to dental school on a full-time basis to study orthodontics, was entitled to deduct his costs of the orthodontics education. The taxpayer continued his general dentistry practice on a part-time basis during the time he was in dental school, and after the postgraduate education, limited his practice to orthodontics. The IRS concluded that the costs incurred for the studies in orthodontics were incurred to maintain or improve the taxpayer's skills as a dentist, and did not qualify him to enter a new trade or business. In reaching this conclusion, the IRS cited Example (4) of Reg. §1.162-5(b)(3)(ii), which indicates that the costs of a program of study and training for psychoanalysis by a practicing psychiatrist are deductible, as the program maintains or improves skills required in the taxpayer’s trade or business. Thus, in Rev. Rul. 74-78, the IRS did not deem the practice of general dentistry as a different trade or business than the practice of orthodonture.

In *Iglesias v. Commissioner*[15], the taxpayer, a licensed general physician and second year resident in psychiatry, underwent psychoanalysis. As part of the residency, the taxpayer worked a forty-hour week, one third of which was spent in classes and two thirds of which was spent in various patient care activities in the hospital. In addition, the taxpayer was on call at the hospital for twelve hours per week. The psychoanalysis was not a requirement of the psychiatry residency, nor a requirement to become a board-certified psychiatrist. The Commissioner argued against deductibility of

the psychoanalysis costs on the grounds that the medical specialty of psychiatry is a different trade or business than the trade or business of general medicine. The court declined to rule on this point. Although the court noted that Example (4) of Reg. §1.162-5(b)(3)(ii) addressed a practicing psychiatrist, the court concluded that the taxpayer's services rendered as a psychiatry resident meant he was already engaged in the trade or business of "a licensed physician treating psychiatric patients". Since the taxpayer was already engaged as "a licensed physician treating psychiatric patients", the psychoanalysis maintained or improved his skills , and therefore, the costs associated with the psychoanalysis were deductible.

Occupations with Professional Certification:

In *Ted Radin*[16], the taxpayer, an actuarial analyst, endeavored to pass the Society of Actuaries exam. Passing the initial seven parts of the exam offered by the Society conveys the title of "Enrolled Actuary" ("EA"), and completion of all ten parts of the exam conveys the title of "Fellow of the Society of Actuaries" ("FSA"). In the year under issue (1983), and even now, actuaries are not licensed by the states. The taxpayer deducted the costs of actuarial books and materials as well as actuarial examination fees, on the grounds that these expenses were incurred to maintain his present position and salary. The court pointed out that an EA can prepare and submit certain pension plan documents to the Internal Revenue Service, and that a FSA has additional rights and privileges beyond those of an EA. Based on these factors, the court determined that, under professional standards, the services the taxpayer could provide as an actuarial analyst were different than those he could render as an EA or a FSA. Since the professional standards envisioned different services, the duties

of an actuarial analyst and an EA or a FSA cannot be the same, and education costs to become an enrolled actuary or a FSA are therefore not deductible.

Internal Determinants of Duties

Occupations without Licensure or Professional Certification:

In *Albert C. Ruehmann III*[17], the Commissioner argued against deductibility of the taxpayer's graduate tax studies on the basis that the taxpayer had not yet established himself in a trade or business. The court, however, determined that the taxpayer's four months of practice as an attorney, after graduation from law school but prior to entrance into the master's of tax law program, were sufficient to demonstrate that the taxpayer had established himself in the trade or business of practicing law. Since the court found that the taxpayer had indeed been engaged in a trade or business at the time the education costs were incurred, the next issue was whether the education qualified the taxpayer for a new trade or business. The court was not required to determine whether the practice of general law and the practice of tax law were two different trades or businesses, because the Commissioner had conceded this issue in a reply brief submitted earlier to the court. By arguing that the education costs should be denied because the taxpayer had never engaged in a trade or business (in the Commissioner's opinion, four months was an insufficient time for a taxpayer to establish a trade or business), the Commissioner indicated the regulations would permit the taxpayer's deduction of the costs of obtaining his LL.M. degree if the taxpayer was already engaged in the practice of law prior to the education. The IRS apparently made no distinction between the practice of general law and the practice of tax law. Since the court found that the taxpayer had engaged in the

trade or business of law before entering the graduate tax studies program, the court had no option but to hold that the education expenses were deductible.

In *Stephen G. Sherman*[18], in July 1969, the taxpayer secured a two year managerial-administrative position with the Army and Air Force Exchange Service ("AAFES") Viet Nam Regional Exchange. The taxpayer's responsibilities included formulating and monitoring management, contingency and emergency plans, including the phase-down of exchanges in conjunction with troop redeployment; personnel management; and the review and evaluation of major policy and procedures with respect to inventory control, procurement and distribution. Additionally, he represented the Viet Nam region in discussions regarding planning operations with the Department of Defense, the Department of State and legislative officials. In early May 1971, the taxpayer was accepted into the MBA program at Harvard University, and requested a leave of absence from the AAFES. The request was denied on the grounds that his two-year employment term with the AAFES would expire on July 25, 1971, leaving the taxpayer free to pursue graduate studies. While denying the leave of absence, the AAFES encouraged the taxpayer to apply for employment upon completion of his graduate studies. After the taxpayer's employment contract with the AAFES terminated in July 1971, the taxpayer entered the MBA program, presumably in September 1971, and graduated in June 1973. During the two years the taxpayer was a full time student in the MBA program, he was not under an employment contract with the AAFES or any other employer. In late 1972, while still at Harvard, the taxpayer applied for re-employment at AAFES, but was denied due to reduced staff needs. Upon graduation from Harvard in August 1973, taxpayer became Director of Planning and Research at Radix Corporation. The taxpayer deducted the costs of his MBA education at Harvard

University. The court concluded that the taxpayer's trade or business was business administration and that he had been engaged in the trade or business of business administration both before (with the AAFES) and after (with Radix Corporation) the education. Since the taxpayer was engaged in the same trade or business both before and after the education, the time during which the taxpayer was unemployed and completing his education was treated as time spent in the taxpayer's trade or business, under the hiatus principle. Since the Commissioner only argued that the taxpayer had not established himself in a trade or business before the education, that the taxpayer was not carrying on a trade or business while in graduate school and that the taxpayer's suspension from his trade or business was not temporary or definite, the court assumed that the education costs otherwise met the standards of deductibility stipulated in Reg. §1.162-5 and allowed those costs as a deduction.

In *Frank S. Blair*[19], the taxpayer was hired by Sherwin Williams Co. as a personnel representative after earning her undergraduate degree on a full time basis. Prior to attending college, the taxpayer had been a homemaker for fourteen years, but worked part-time and accumulated the equivalent of five and one-half years of bookkeeping and payroll accounting experience. As a personnel representative, the taxpayer made hiring recommendations, suggested personnel policy changes, established salaries for various jobs within the firm and assisted employees with health and other employee benefits. In January 1975, the taxpayer entered a two-year part-time evening MBA program, while continuing to work full time for Sherwin Williams. When the taxpayer was promoted to personnel manager in December 1975, her duties became primarily supervisory. She received a substantial increase in pay and became responsible for hiring decisions and for the department budget. The taxpayer received her MBA in

December 1976. The Commissioner argued that the positions of personnel representative and personnel manager were two different trades or business, and that the MBA qualified the taxpayer for the position of personnel manager. Although the court noted that a personnel representative could only make recommendations while a personnel manager could make decisions, the court also recognized that there was substantial overlap in the taxpayer's responsibilities as personnel representative and personnel manager. The court concluded that neither the acquisition of a new title or the difference with respect to making recommendations versus making decisions were sufficient to constitute different duties for purposes of Reg. §1.162-5(b)(3), and held the educational expenditures deductible.

In *Robert C. Beatty*[20], the taxpayer joined McDonnell Douglas in January 1972, after receiving bachelor's and master's degrees in aeronautical engineering. The taxpayer's title was "Engineer/Scientist Specialist" and his initial responsibilities primarily involved the design and testing of technology used to guide, navigate and control aircraft flight. The taxpayer's career objective was to move into engineering operations management, by becoming involved in software integration, which involved the management of the technical aspects of guidance system development, coordination of the integration of the guidance system into the flight computer program, and development of software for testing and evaluation. These activities required him to coordinate the work of numerous other engineers within the firm across area specialties, and to interact with related professionals inside and outside the firm, as well as resolve conflicts between individuals, groups and subcontractors. The taxpayer matriculated in a Master's of Science in Administration program, which was oriented towards management administration. In holding the costs of the education

deductible, the court concluded that the education maintained or improved the taxpayer's skills in his trade or business, despite the fact that the bulk of the taxpayer's duties revolved around engineering responsibilities. The court could not ". . . perceive any discrete line of demarcation between the engineering aspect of his employment and the administrative role he played in the software integration area; . . ." The court concluded that the education did not qualify the taxpayer for a new trade or business, because ". . . the studies merely reflected a change in his duties at McDonnell." That is, the change in the taxpayer's duties after the education was not sufficiently different than his duties before the education to be treated as a new trade or business for purposes of Reg. §1.162-5(b)(3).

In *Daniel D. Granger*[21], the taxpayer was employed as a Fifth Key Carrier by a supermarket chain, checking-out customers, maintaining shelves and ordering inventory. The Fifth Key Carrier position, on the lower management level of a retail food establishment, is lower in supervisory and managerial authority and responsibility than Fourth, Third, Second and First Key Carrier, where the store manager is First Key Carrier. The taxpayer worked the night shift at the supermarket. Since no store manager (First Key Carrier) or anyone with more supervisory authority was on duty at night, the taxpayer served as the manager on the night shift. Upon his own initiative, the taxpayer attended a food marketing management program, earning a certificate upon completion. The employer did not require the education, but after obtaining the certificate, the taxpayer was subsequently promoted through the ranks to First Key Carrier. The court upheld the taxpayer's deduction for the costs of the education, finding that the education ". . . bore a substantial and direct relationship to the skills he needed in his ascension in the field of retail food management." The court concluded that, for purposes of Reg.

§1.162-5(b)(3), the duties of all ranks of Key Carriers were substantially the same. Interestingly, the court also found that the education did not qualify the taxpayer for a new trade or business because the taxpayer, despite holding the title of Fifth Key Carrier, functioned as a First Key Carrier when he worked the night shift.

In *Owen Gilliam III*[22], the taxpayer, a level T-5 employee at Honeywell, deducted costs of college level courses in business and computer programming. Although not required, the taxpayer was motivated to take the courses after his supervisor informed him that taking the college level courses would improve his chances for promotion. The taxpayer's principal duties were to program and repair computers. A promotion to T-6 or C-6 status would still require him to perform that work, but also allow him to become involved in management decisions, such as handling reports, scheduling and planning complex programs. The court concluded that the college level courses maintained and improved the taxpayer's skills as a computer programmer, and also found the taxpayer's testimony credible that a promotion to grade 6 would involve basically the same skills and requirements of a grade 5, but with greater responsibilities.

In Private Letter Ruling 9112003, the taxpayer, a practicing attorney for four years, intended to resign from his position as associate attorney and return to school to obtain a master's degree in tax law. During the course of his employment with two law firms over the four-year period, the taxpayer did minimal tax-related legal work. The master's in tax law was expected to take nine months on a full time basis to complete, after which, the taxpayer intended to return to the practice of law. The Commissioner cited *Ruehmann* to conclude that the master's of tax law merely improves the taxpayer's skills in his existing trade or business, rather than qualifies him for a new one. Again, the IRS made no

distinction between the practice of general law and the practice of tax law.

In *Will M. McEuen III, et ux. v. Commissioner*[23], the taxpayer received an undergraduate degree in economics and mathematics in 1992, and began working for Merrill Lynch ("Merrill") later that year. The taxpayer's position there was that of financial analyst. In the financial analyst program, one could remain for a maximum of three years but an MBA was required to advance to the position of associate. At the end of that time with Merrill, the taxpayer had not yet acquired an MBA, so she left Merrill and accepted an analyst position with Raymond James Financial, Inc. ("James"). The analyst program there was of two to three year duration and again, an MBA was required to become an associate. The record indicates that analysts and associates were not always assigned to all of the same securities work. At times, analysts worked directly with a vice president or a managing director, without an associate. The record also indicates that the duties of analyst and associate were, in fact, similar. The court noted that in the investment banking industry at that time (1995 and 1996), an MBA degree was required for the associate position. While at James, the taxpayer resigned her position to enroll in a graduate business program. Upon graduation from the graduate business program, the taxpayer was accepted into the "General Management Program" of a home furnishings manufacturer and became an "associate brand manager".

In claiming deductibility of her educational expenditures, the taxpayer argued that she was in the investment banking business and the expenses were incurred to maintain or improve her skills in the trade or business of investment banking. Alternatively, she argued that the expenditures were required to maintain her existing employment relationship, status or rate of compensation.

McEuen represents somewhat of a departure from the other cases reviewed in this paper, in that the court addressed the standards for non-deductibility in both Reg. §1.162-5(b)(2) and §1.162-5(b)(3). In holding for the Commissioner, the court classified the analyst position as a "subordinate temporary position", while classifying the associate position as a "permanent career position", from which one could advance further through the firm. The court cited corporate literature in which James identified itself as consisting of "twenty-three investment bankers and eight financial analysts." The court inferred from this that James itself did not view analysts as investment bankers. Based on the classification of the analyst position as temporary and James' description of the professional staff, the court concluded that although the taxpayer was performing investment banking services, she had not yet met the minimum educational qualification as an investment banker, and the expenditures for the MBA were incurred to meet those requirements.

In addition, the court noted that even if the analyst and associate positions were not two different trades or businesses, under Reg. §1.162-5(b)(3), the deduction for the education costs would be denied on the basis that the MBA would enable the taxpayer to perform significantly different duties and activities after the education. The change in the taxpayer's <u>potential</u> scope of duties provided by the education was sufficient to constitute a new trade or business.

EQUITABLE TREATMENT?

To reach a conclusion on whether the decisions in this area result in equitable treatment for the various occupations under the tax law, three questions must be answered:

(1) Do the decisions based on external determinants of duties result in equitable treatment for various

occupations, when considering only decisions based on external determinants of duties?

(2) Do the decisions based on internal determinants of duties result in equitable treatment for various occupations, when considering only decisions based on internal determinants of duties?

(3) Do the decisions result in equitable treatment across occupations when considering decisions based on both external and internal determinants of duties?

First, do decisions based on external determinants of duties result in equitable treatment across various occupations, when considering only decisions based on external determinants of duties? For the most part, taxpayers appear to be equitably treated in decisions involving external determinants of duties, but an argument could be made that that dentists and doctors have received preferential treatment relative to other occupations in terms of the tax deductibility of their occupation-related education costs.

Under Rev. Rul. 74-78, once a taxpayer qualifies and practices as a general practice dentist, the costs of an education to obtain a specialty beyond general dentistry are deductible, as they are deemed to maintain or improve the taxpayer's trade or business as a dentist. In other words, under Rev. Rul 74-78, for purposes of Reg. §1.162-5(b)(3), the duties of a general practice dentist are the same as the duties of an orthodontist. Rev. Rul. 74-78 does not address the role of dental board certification of orthodonture, nor state licensure of dental specialties.

The American Dental Association recognizes and regulates nine dental board specialties, and stipulates the advanced education and experience requirements.[24] Example (3) of Reg. §1.162-5(b)(3)(ii) indicates that a two-week course reviewing new developments in several medical specialty

fields are deductible by a general practitioner of medicine, since the course maintains or improves skills required in the taxpayer's trade or business. Reg. §1.162-5(c)(1) indicates that refresher courses or courses dealing with current developments are deductible, as long as they are not the minimum requirements to enter the trade or business or to qualify the taxpayer for a new trade or business. Taxpayers generally view Example (3) of Reg. §1.162-5(b)(3)(ii) and Reg. §1.162-5(c)(1) as the authority for the deductibility of continuing professional education courses [e.g., continuing professional education ("CPE"), continuing medical education ("CME"), continuing legal education ("CLE"), etc.]. While continuing education is typically taken by professionals to maintain their license or professional certification, dental or medical specialty education is typically undertaken to obtain a new license or professional certification. It is clear that significant education and experience is required to obtain a dental board certification. Given the significant education and experience requirements for dental board specialty certification, it does not seem equitable to argue that the education required for board certification for dentists is the equivalent of the two-week continuing education course for other occupations contemplated by Reg. Sec. 1.162-5(b)(3).

The more expansive view of duties for dentists established by Rev. Rul. 74-78 (particularly when the revenue ruling notes that the general practice dentist confined her practice to orthodontics after the education) is to be contrasted with the narrow view of duties in decisions involving accountants and landscape architects. The trade or business of an unlicensed accountant is considered different from a CPA, because an unlicensed accountant can serve only a portion of clients requiring accounting and tax services.[25] The trade of business of an unregistered landscape architect is considered a different from a registered landscape architect, because an

unregistered landscape architect can service only a portion of clients requiring landscape architecture services.[26] Dental patients typically visit their general practice dentist annually or semi-annually, but seek out dental specialists only when the need arises. For example, dental patients typically seek the services of an orthodontist only once. If differences in the types of clients a taxpayer can serve before the education versus after the education is indicative of a change in duties for unlicensed accountants and unregistered landscape architects, is it equitable to maintain that a general practice dentist is serving the same patients as an orthodontist?[27]

If external determinants of duties are relied upon to decide whether the taxpayer's duties before and after the education involve the same general type of work, are there differences in the weight placed on the external determinants of duties applicable to the particular occupation? What is the role of state licensure and professional certification in deciding if the taxpayer's duties before and after the education are of the same general type? Some occupations have licensure only, while others have licensure and professional certification, and still others have the latter only.

Orthodontists and general practice dentists are in the same field (dentistry) and RNs and LPNs are in the same field (nursing). Orthodontists require additional education beyond that to become a general practice dentist. RNs require additional education beyond that of a LPN. Professional recognition for general practice dentists is conferred by state license, and for orthodontists, by dental board specialty certification. Professional recognition for both LPNs and RNs is conferred by state license. Yet, under Rev. Rul 74-78, the duties of an orthodontist (board certification) are the same as the duties of a general practice dentist (license), while, pursuant to *Robinson*, the duties of a LPN (license) are not the same as the duties of a RN (license). If nurses cannot deduct

the education costs to move from a LPN to a RN license, is it equitable to allow dentists to deduct the costs of moving from a DDS/DMD license to a board specialty certification?

In *Iglesias*, the Commissioner argued that the trade or business of psychiatry is different from that of general medicine, and therefore, the taxpayer's costs of psychoanalytic training should not be deductible. Interestingly, this argument is the opposite of the Commissioner's earlier argument in Rev. Rul. 74-78, that a specialty field is the same trade or business as a general field. The *Iglesias* court declined to decide whether the trade or business of psychiatry is different from general medicine. Although the court noted that board certification did not require the doctor to undergo psychoanalysis, and that it was not part of the hospital program in which the taxpayer was a resident, the court did not address whether completion of the residency in psychiatry was required before the physician (i.e., a medical doctor or "M.D.") could hold himself out as a board certified psychiatrist and seek employment as such.

The Occupational Outlook Handbook of the Bureau of Labor Statistics of the U.S. Department of Labor indicates that M.D.s seeking board certification in a specialty must complete a residence in the specialty and pass a final examination for certification by the American Board of Medical Specialists. A resident is always under the supervision of, and is responsible to, a supervising physician educator of the same specialty in the hospital. The latter must certify that the resident has satisfactorily completed the residency program as part of the board certification process.

Although the taxpayer in *Iglesias* was a licensed general physician by the second year of his residency, it was unclear whether he practiced as a general physician before beginning his psychiatry residency. This is an interesting omission because the simple holding of a license does not necessarily

mean that the taxpayer practices in that occupation. The deductions permitted under I.R.C. §162 are allowed only when they incurred in conjunction with the carrying on of a trade or business. The *Iglesias* court found that the taxpayer's psychiatric patient services during the residency period were sufficient to consider the taxpayer already engaged in the trade or business of "a licensed physician treating psychiatric patients". In other words, the court preferred to characterize Iglesias' services required as part of his residency as the equivalent of carrying on a trade or business, rather than as the practical experience prerequisite to enter it. While the taxpayer of Rev. Rul. 74-78 had practiced general dentistry before commencing the orthodonture education, it appears that taxpayer in *Iglesias* did not practice general medicine before his psychiatry residency program. If he had, the court would have been able to rely upon Rev. Rul. 74-78, and would not have needed to characterize the practical experience component of the residency program as the carrying on of a trade or business. If *Iglesias* was already engaged in the trade or business of a licensed physician treating psychiatric patients, and therefore his costs of psychoanalysis were deductible, then, following Rev. Rul. 74-78, would not the education costs of his psychiatric residency, if any, also be deductible? This point was never brought up by the court or the taxpayer.

Taxpayers in occupations other than medicine have generally not been permitted to treat the practical experience prerequisite for licensure or professional certification as the equivalent of carrying on a trade or business. Consider the following: (1) a medical resident must have completed medical school in order to enter a specialty residency program, and an unlicensed accountant must have completed, generally, an undergraduate degree in accounting to obtain a position in a public accounting firm; (2) a resident must accumulate the required number of specialty hours (both in the classroom and

the hospital) of the residency program, and an unlicensed accountant must accumulate, generally, twenty-four months of attestation practical experience; (3) the resident must complete the residency under the supervision of physician-educators, and an unlicensed accountant must complete the practical experience requirement under the supervision of CPAs; (4) the resident must pass an examination at the end of the residency to become board certified, and an unlicensed accountant must pass an examination to become state certified; (5) both the resident and the unlicensed accountant are paid for the services they render. Despite these similarities, *Iglesias* indicates that a psychiatric resident is already considered engaged in the trade or business of a licensed physician treating psychiatric patients, while *Cooper* and other earlier decisions indicate that an unlicensed accountant is not considered already engaged in the trade or business of public accounting, while performing the services of a licensed accountant under the supervision of a CPA. Given that public accounting work experience prior to licensure is not considered the carrying on of the trade or business of a CPA, is it equitable to treat the practical experience acquired during a medical specialty residency as the carrying on of a trade or business, particularly when the taxpayer has not carried on any trade or business before the residency?

Second, do decisions based on internal determinants of duties result in equitable treatment across various occupations, when considering only decisions based on internal determinants of duties? While, for the most part, taxpayers in decisions involving internal determinants of duties appear to be equitably treated across occupations, this review suggests, however, that an argument could be made that certain occupations have received preferential treatment relative to other occupations in terms of the tax deductibility of their occupation-related education costs.

What constitutes a "sufficient" amount of time for a taxpayer to become established in a trade or business seems to depend upon the taxpayer's occupation. Although neither I.R.C. §162 nor the regulations there under identify the amount of time spent in a particular employee or self employed position as a determinant of whether a taxpayer has established himself in a trade or business, the courts and the IRS do consider this factor. In *Ruehmann*, the court concluded that the taxpayer's four months of practice as an attorney during the summer between graduation from law school and entrance into a graduate tax program, were sufficient to show that the taxpayer had established himself in a trade or business prior to incurring the education costs in question. In contrast, in *McEuen*, the court concluded that, because the taxpayer's two employers had "up or out" policies (i.e., the employee must complete a MBA within three years of hire, or leave), the taxpayer's approximately five years of experience as an analyst could not be counted as time spent in the trade or business of investment banking before incurring the costs of an education required for promotion. If the four months between graduation from law school and graduate tax law school is a sufficient amount of time to establish the taxpayer in a trade or business, is it equitable to say that an analyst's five years of experience with two investment banking firms had not established her in a trade or business?

Although neither I.R.C. §162 nor the related regulations specify how to handle employment arrangements with fixed terms, the issue of fixed employment terms also seems to depend upon the taxpayer's occupation. In *Sherman*, the Tax Court concluded that the taxpayer's two year fixed term of employment with the AAFES was sufficient to show that the taxpayer had established himself in the trade or business of business administration, even though the taxpayer was unemployed from the expiration of his employment contract

until he commenced graduate business school. The taxpayer took a position in private industry upon graduation, but whether the taxpayer's new position as Director of Planning and Research required a MBA or not was never addressed. In contrast, in *McEuen*, the court concluded that, because the taxpayer's term of employment at each of two employer firms was limited to three years unless the taxpayer earned a MBA degree, the taxpayer's combined five years of experience as an analyst did not establish her in the trade or business of investment banking before incurring the education costs. If a two-year term employment with the AAFES is sufficient to establish the taxpayer in the trade or business or business administration, is it equitable to say that five years as an analyst with two investment banking firms was a temporary position?

Third, do decisions result in equitable treatment across occupations when considering decisions based on both external and internal determinants of duties? In *Iglesias* and *McEuen*, both taxpayers had positions with three year "up or out" terms. McEuen's position as analyst required her to successfully complete a MBA program by the end of the three-year term in order to continue and be promoted to associate. Iglesias' position as psychiatric resident required him to successfully complete the residency program by the end of the three year term, the total years of residency required for board certification as a psychiatrist.[28] Residents who fail to complete either the prerequisite training or the exams cannot become board certified. Both taxpayers sought positions that require a combination of practical and educational experiences. The position of associate implicitly requires acceptable performance in the practical on-the-job training at the firm, and explicitly requires educational training. The position of board certified psychiatrist implicitly requires acceptable performance in the practical on-the-job training at the hospital,

and explicitly requires educational training. Both taxpayers were compensated for the time spent in acquiring the necessary prerequisite practical experience.

The *McEuen* court, however, relying upon Reg. §1.162-5(b)(2), held that, although McEuen was performing investment banking services, she had not yet met the minimum education requirements for qualification in that trade or business. In contrast, the *Iglesias* court held that the taxpayer's time spent working in the hospital as a psychiatric resident was time spent in the trade or business of a "licensed physician treating psychiatric patients". The *Iglesias* court made no mention of Reg. §1.162-5(b)(2) and seemed to ignore the fact that, although the taxpayer was rendering psychiatric services to patients, he had not yet met the minimum requirements to qualify as a board certified psychiatrist.

CONCLUSION

Employment-related education costs can be significant for many taxpayers, and deductibility of those costs can ease the financial burden. Taxpayers must be able to demonstrate that those educational costs not only meet the standards for deductibility, but also do not run afoul of the standards for non-deductibility. However, in relying upon the record of IRS and court decisions, taxpayers may find that the record contains inconsistencies and inequities.

This paper has reviewed the record of IRS and court decisions with respect to the deductibility of employment-related education costs under I.R.C. §162. In making a comparison of the taxpayer's duties before and after the education (as a means of determining whether the taxpayer has remained in the same trade or business or has qualified to enter a new trade or business), the courts rely, when possible, upon external determinants of the taxpayer's duties, such as state

licensure and/or professional certifications, or upon internal determinants of the taxpayer's duties, such as the taxpayer's or employer's own delineation or description of duties. The analysis of the treatment accorded taxpayers across various occupations suggests that taxpayers in certain occupations have received preferential treatment with respect to the deductibility of their education costs relative to taxpayers in other occupations.

A number of questions remain. What is the role of external determinants of duties when more than one applies to a particular occupation? This is an important issue for occupations such as dentist and doctors, which involve a state license and either board certification or a second license. What is, or should be, the weight accorded each of the external determinants? What happens when a state institutes licensing of a dental or medical specialty that previously was only board certified? Does it alter the deductibility of education related costs? What about situations where the character of the practice before the education differs from the character of the practice after the education? Is the practice of general dentistry the same as a practice focused exclusively on orthodontics (i.e., Rev. Rul. 74-78)? Is the practice of general law the same as a practice focused exclusively on tax law (i.e. PLR 9112003)? Is obtaining orthodontic training the same thing as undergoing psychoanalysis? Example (4) of Reg. §1.162-5(b)(3)(ii) indicates that the costs of a program of study and training for psychoanalysis by a practicing psychiatrist are deductible, as the program maintains or improves skills required in the taxpayer's trade or business. Rev. Rul. 74-78 and *Iglesias*, among other decisions, cite Example (4) of Reg. Sec. 1.162-5(b)(3)(ii) in concluding that the taxpayer's education costs were deductible as they are deemed to be incurred to maintain or improve the taxpayer's trade or business skills. Psychoanalysis is a therapy employed by psychiatrists,

psychologists and social workers as part of psychological counseling to identify the unconscious factors that affect behavior and emotions. Conversely, state law prohibits anyone who is not part of the field of dentistry from practicing orthodonture

The regulations under Sec. 162 were last amended in 1967, when the United States economy was more an industrial economy than the service economy it is today. It is likely since 1967, the increased role of services-type occupations in the economy has been accompanied by a growth in the number of members of professional organizations and boards, as well as a significant increase in the number of occupations, specialties and sub-specialties licensed by states and/or certified by professional organizations or boards. It may be time for Congress to review Section 162 as it applies to employment-related education costs.

ENDNOTES

[1] Smith, Adam. The Wealth of Nations. New York: Alfred A. Knopf, Inc., 1991.

[2] TC Summary Opinion 2004-107 (2004)

[3] *Ronald F. Weiszmann*, 52 T.C. 1106 (1969); *William D. Glenn*, 62 T.C. 270 (1974); *Davis v. Commissioner*, 65 T.C. 1014 (1976)

[4] e.g., *Howard Sherman Cooper*, TC Memo 1979-241 (1979)

[5] e.g., Rev. Rul. 69-292, 1969-1 CB 84; *William D. Glenn*, 62 TC 270 (1974); *David Cooper*, TC Memo 1978-117 (1978); *Velma Archie*, TC Memo 1978-425 (1978); etc.

[6] *Ted Dierker*, TC Memo 1994-422 (1994)

[7] *Stephen Galligan* , TC Memo 2002-150 (2002)

---

[8] e.g., *Rombach v. US* , 27 AFTR2d 71-918 (1971); *John K. Lunsford et al.*, TC Memo 1973-17 (1973)

[9] e.g., *Danielson v. Quinn*, 45 AFTR 2d 80-1555 (1980); *David Roeberg* , TC Memo 1970-236 (1970); *Patrick L. O'Donnell* , 62 TC 781 (1974); *Michael Joseph Goldberg* , TC Memo 1984-617 (1984)

[10] *Mathew Reisinger*, 71 TC 568 (1979)

[11] *David A. Goldstein*, TC Memo 1987-47 (1987)

[12] *John M. Gannon* , TC Memo 1977-283 (1977)

[13] 78 TC 550 (1982)

[14] 1974-1 C.B. 44

[15] 76 TC 1060 (1981)

[16] TC Memo 1987-348 (1987)

[17] TC Memo 1971-157 (1971)

[18] TC Memo 1977-301 (1977)

[19] TC Memo 1980-488 (1980)

[20] TC Memo 1980-196 (1980)

[21] TC Memo 1980-60 (1980)

[22] TC Memo 1986-90 (1986)

[23] *supra* note 2

[24] According to the "Report of the American Dental Association ("ADA")-Recognized Dental Specialty Certifying Boards" (April 2004), there are nine ADA board recognized dental specialties: dental public health, endodontics, oral and maxillofacial pathology, oral and maxillofacial

radiology, oral and maxillofacial surgery, orthodontics, pediatric dentistry, periodontology and prosthodontics.[24] The report indicates that the years of advanced education required in addition to the DDS or the DMD degree for these specialties ranges from two to four years, and that the total years of specialty experience plus advanced education required in addition to the DDS or the DMD degree ranges from two to five years. Orthodontics is reported to require two to three years advanced education beyond the DDS or the DMD, and a total of four years of advanced education and specialty experience beyond the DDS or the DMD for board certification. See American Dental Association at http://www.ada.org/prof/ed/specialties/natcert.asp. The Occupational Outlook Handbook of the Bureau of Labor Statistics of the U.S. Department of Labor (April 2005 version) also indicates that approximately seventeen states license dental specialties (see United States bureau of Labor Statistics at http://stats.bls.gov/oco/.

[25] e.g., *Howard Sherman Cooper*, TC Memo 1979-241 (1979); Rev. Rul. 69-292, 1969-1 CB 84; etc.

[26] TC Memo 1994-422 (1994)

[27] Other contractual parties to taxpayers' dental care would also likely argue that general dental services are different from orthodontic services. Insurance companies providing reimbursement of dental costs likely do not classify general dentistry and orthodontics as one in the same service, and in fact, most insurance policies that offer dental coverage almost always have differential reimbursement terms for general dental and orthodontic care. General dental services typically have annual reimbursement limits while orthodontic services typically have lifetime reimbursement limits.

[28] American Board of Physician Specialties at http://www.abpsga.org/certidication/boc_comparison.html - "Certification Requirements: A Comparison between ABPS, ABMS & AOABOS"

THE INCOME TAX AND THE STATE OF A UNION IN AMERICA

by Cindy Lou Beale*

I. INTRODUCTION

One of the hottest topics in American social and legal policy today is that of the legal recognition of the relationship between same-sex partners, whether it is a same-sex marriage[1], a civil union[2], or some variation on the theme.[3] A host of legal issues now swirl around these couples, including:

a. which states will recognize their relationships[4],
b. how portable are their new-found legal relationships to other states given how many states have declared these unions illegal[5], and
c. perhaps, most importantly, how secure are their relationships if one partner can simply move to a non-recognizing state, thus effectively ending the relationship?[6]

As with any new legal status, the legal ramifications of same-sex unions are legion.[7] Considering the nation's political climate, the split among the states regarding the validity of same-sex unions, and the federal government's anti-same-sex marriage position as codified in the Defense of Marriage Act since 1996[8], the waters will probably remain murky for quite some time.

The purpose of this paper is to examine the legal and

---

*Assistant Professor of Taxation & Legal Studies, Pace University, Lubin School of Business, New York

demographic changes that have occurred since 1948 when the joint return was created as well as the assumptions and other motivating factors behind its creation and to determine if the continued existence of that filing status in our federal tax system is appropriate.

II. MASSACHUSETTS SAME-SEX COUPLES' TAX-FILING PROBLEMS

Like most Americans, every year same-sex couples will file their income tax returns, federal and state (where applicable). Something as banal as this annual rite has the potential of throwing many same-sex couples into an ethical dilemma of the first order. For those same-sex couples fortunate enough to reside in Massachusetts and who have been legally married there, the situation on first glance seems to be pretty clear: the Massachusetts Department of Revenue issued a Technical Information Release[9], which provides that same-sex spouses (married on or after May 16, 2004) should file as married persons, jointly or separately, for Massachusetts state income tax purposes.[10]

However, since Congress passed DOMA[11] in 1996, each partner is legally required to use the filing status of "single" when he or she files his or her federal income tax return.[12] In Massachusetts, same-sex partners then face a risk of committing perjury when he or she signs his or her federal income tax return.[13]

There is no clear answer to this particular ethical dilemma. The situation, however, does pose at least one other issue: how relevant is the filing status of married filing jointly today?[14] To be sure a taxpayer's federal marital status affects his or her tax liability in a variety of ways, but not always consistently or favorably.[15] Not only is the present treatment of the marital

unit inconsistent and inaccurate, but it is based on outdated, unexamined premises.[16]

III. DEMOGRAPHIC CHANGES SINCE 1948

In 1948 when the joint return was established, certain assumptions prompted its creation as a response to perceived inadequacies in the system.[17] One of those assumptions was that the married couple had a "traditional" family in which there was only one earner in each family.[18] This assumption was not true in 1948 when the joint return was enacted because 23.1% of all married women participated in the labor force.[19] It is even less true today because in 2003, 61% of all married women worked.[20]

The 203% increase in the proportion of working married women working since 1948 is consistent with the fact that traditional families consisting of breadwinner dads and stay-at-home moms now account for a mere one-tenth of all households.[21] Furthermore, a record number of children—33%--are now born to single parents, many of them to underemployed, uninsured mothers.[22] Moreover, married couples with children, which made up nearly every residence a mere century ago, now total just 25%--with that number projected to drop to 20% by 2010, says the Census Bureau[23], when nearly 30% of homes will be inhabited by someone who lives alone.[24]

Fueling this demographic change is the fact that more people are setting up same-sex households. From 1990 to 2000, the percentage of gay male couples with children increased from 5% to 22% and the percentage of lesbian couples with children increased from 22% to 34%.[25]

Also, unmarried heterosexual couples households have increased nearly 50% from 1996 through 2002.[26] Heterosexuals are marrying later. From 1950 through 2002, the average age for first-time marriage for males increased from 23 to 27 years old and, for women, from 20 years old to nearly 26.[27] Couples are also splitting up in greater numbers. From 1950 through 2002, the percentage of divorced men increased from 2% to 8% and the percentage of divorced women, from 2% to 11%[28]; and more adults will remain unmarried.[29]

Finally, more Americans, on average, are living longer, which will make for an expanding population of widows and widowers as Baby Boomers age.[30] Meanwhile, more seniors are divorcing so they can qualify for Medicaid, while others are living together instead of remarrying to avoid losing their survivor pension or health-care benefits.[31]

Given this vast demographic shift and the very remote possibility of full federal and state legal recognition of same-sex unions in the near future, time and energy would be better spent in changing our federal income tax system to one that is based on the individual as the more appropriate unit of taxation.

IV. DEVELOPMENT OF THE FILING STATUS CATEGORIES

Before implementing fundamental changes in the system, it is important to examine some of the complexities involved in its creation. Prior to the enactment of the joint return, Congress examined alternative methods of correcting discrimination which arose in the treatment of family income under Federal income tax law.[32]

From 1913 to1948 the individual taxpayer was the only filing category.[33] The language of the first income tax statute based on the Sixteenth Amendment imposed a tax "upon the entire net income arising or accruing from all sources…to every citizen of the United States…and to every person residing in the United States, though not a citizen thereof".[34] The Revenue Act of 1916 explicitly taxed "the entire net income received…by every individual".[35]

In 1918, Congress gave married taxpayers the option of filing their federal income taxes jointly[36], but since there was only one rate schedule for all taxpayers and the rates were progressive, combining the spouses' incomes on one jointly filed tax return was disadvantageous.[37] Accordingly, most married taxpayers who had two taxable incomes filed separately to take advantage of the progressive rate schedule.[38]

One such couple were Guy C. Earl and his wife, Ella, who had signed a contract in 1901 in Oakland, California, in which they agreed to split all of their earned income equally.[39] Because there was no income tax in 1901, Mr. and Mrs. Earl were innocent of any tax avoidance motive[40] when they filed separate tax returns in 1920 and 1921.[41] Yet in March 1930 the Supreme Court held in *Lucas v. Earl*[42] that Guy Earl was taxable on the full amount of his personal service income (salary and attorney's fees) and could not assign it for tax purposes to his wife, Ella, even though their 1901 contract was valid under California law, because Guy had earned the salary and fees.[43]

In upholding Mr. Earl's employment contract over his marital contract, the Supreme Court in *Lucas v. Earl* accomplished several things. First, it enunciated the assignment of income doctrine[44], which makes it virtually impossible for a taxpayer with income from wages, salaries, or

professional fees to shift volitionally these items to other taxpayers, such as a spouse or a child, to "split" taxpayer's earned income and take advantage of the progressive rate schedule.[45] Second, the Court clearly upheld Mr. Earl's employment contract over his marital contract, thus reinforcing the traditional common-law concept that legal ownership followed title.[46] Without such ownership, Mr. Earl would not have had any income to assign.[47] So, ownership and the concomitant dominion and control of the earned income that accrued to the owner at the moment he or she earned the income would ultimately determine the appropriate taxpayer in the marital unit.[48]

The holding in *Earl* was put to the test a mere seven months later in *Poe v. Seaborn*.[49] A husband and wife resided in the State of Washington, a community property state, and their taxable income consisted of Mr. Seaborn's salary, and investment income and profits on sales of real and personal property.[50] All of the Seaborn's property constituted community property as neither spouse had any separate property or income.[51] Each spouse filed a separate individual federal income tax return on one-half of the community income, which the IRS opposed, arguing that all of the income should have been reported on the husband's return.[52]

The Supreme Court held for the Seaborns, rejecting the government's theory that the husband's power to manage community property warranted taxing all the community income to him.[53] Instead, the Court held that one-half of the community income was taxable to each spouse. *Lucas v. Earl* was distinguished as involving an assignment (under an agreement made by a married couple domiciled in a common-law state) of earnings that would have belonged to the husband in the absence of the assignment, while in *Poe v. Seaborn* "*by*

law, the earnings are never the property of the husband, but that of the community."[54] (*emphasis added*).

Following the *Poe* case, the tax status of a married couple in a community property state differed from that of a married couple in a common-law state in two fundamental ways.[55] First, each community property spouse paid the same tax as an unmarried person with one-half the aggregate community income because there was one, progressive tax rate structure.[56] That result obtained in common-law states only in the unusual case of a married couple whose income was generated one half by each spouse and whose investment income, if any, was also equally divided between them.[57] Second, the federal income tax burden for equal-income married couples was identical in community property states, whether the income was attributable to one spouse or to both.[58] This concept came to be known as "couples' neutrality", meaning that couples with the same taxable income have the same income tax liability. In common-law states, since there was no couples' neutrality, the tax liability of equal-income married couples could vary widely, since it depended on the amount attributable to each spouse.[59]

The income tax advantages of living in a community property state for married couples soon became apparent, and there was a stampede among the states to change from common-law to community property states.[60] Oklahoma and Oregon passed do-it-yourself community property laws, which permitted married couples to elect to be governed by the newly enacted community property systems of these two states.[61] In the 1944 decision of *Commissioner v. Harmon*[62], the Supreme Court ruled that these "opt-in" community property systems were substantially the same as the income-splitting contract between husband and wife that was held ineffective for federal tax purposes in *Lucas v. Earl*.[63] The Court went on to

announce that only a non-elective system of community property, "made an incident of marriage by the inveterate policy of the State," could qualify for income-splitting under *Poe v. Seaborn*.[64]

The result of the *Harmon* case was that the community property system was effective for federal income tax purposes if under local law the couple could "opt out" (as permitted in most traditional community property states), but not if they had to "opt in".[65] Oklahoma and Oregon promptly replaced their optional community property systems with mandatory ones, which were accepted as effective by the IRS.[66] Hawaii, Nebraska, Michigan, and Pennsylvania also joined the community property parade, and by 1948 similar action was under discussion in states as far removed from the influence of Spanish law as Massachusetts and New York.[67]

Congress responded to the community property epidemic in 1948 by deciding to authorize all married couples to aggregate their income and deductions on a joint return and to pay a tax equal to twice what a single person would pay on one-half their consolidated taxable income.[68] This device was virtually the same in its effect on federal revenue as standing idly by while the whole country adopted the community property system. Enactment of the income-splitting joint return meant that the political credit for reducing taxes was concentrated in Congress rather than dispersed among the state legislatures.[69] Unlike an across-the-board cut in tax rates, the joint return could be supported as a way of terminating both the historic federal income tax disparity between community property and common-law states and the special opportunities for intraspousal income splitting that were available to married couples with income-producing property.[70]

While the enactment of the joint return produced *couples' neutrality* nationwide, it was not *marriage neutral.* Under the new regime, a married couple paid a tax equal to twice what a single person would pay on one-half their consolidated taxable income; however, if a single person had a taxable income equal to that of a married couple, the single person would pay the same amount of income tax as the couple.

For example, consider Adam and Anna, a married couple with $50,000 of taxable income earned solely by Adam; Betty and Bob, also a married couple, who have $50,000 of taxable income, with $25,000 earned by each; and Debbie, an unmarried woman who lives alone and also has a taxable income of $50,000. If the tax rate is 0% on the first $10,000 of taxable income, 15% on the next $20,000 and 30% on the next $30,000, Adam and Anna, and Betty and Bob can effectively split their respective incomes as each couple is one taxable unit. Thus, each couple's total tax liability would be $4,500: ([$10,000 X 0%] + ($15,000 X 15%)] X 2, regardless of whether the couple had a one income-earner or a two income-earner marriage.

Debbie cannot split her income as the two married couples can. Instead, she is subject to the "brutality" of the progressive rate schedule and must pay federal tax of $9,000: ($10,000 X 0%) + ($20,000 X 15%) + ($20,000 X 30%), or $4,500 more than her married friends who had the identical amounts of income—double their tax liability.[71] This amount became known as the "single's penalty", and in the case of Adam and Anna, a "marriage bonus". [72]

The singles' penalty was attacked on the grounds that:

a. taxes should be independent of marital status,
b. the disparity between the joint rate structure and the singles rate structure, even if partially justified by

the increased cost of supporting the breadwinner's marital partner, was excessive, particularly if account was taken of the economic value of the second spouse's untaxed household services, and

c. similar benefits should be granted to other persons, such as widows and widowers with dependents, whose incomes also had to support two persons rather than one.[73]

In 1969, Congress responded to the continuing complaints about the onerous singles' penalty by creating a new rate schedule for unmarried taxpayers, under which their liability could not exceed a married couple's tax by more than 20% at any taxable income level.[74] As a result of this change, in addition to the singles' penalty, a "marriage penalty"[75] was created, which still exists until today, although it has been eliminated in the standard deduction and in the 15 percent bracket through December 31, 2010 as a result of the Working Families Tax Relief Act of 2004.[76]

Since 1969, if two single people, each with the same amounts of taxable income, get married and continue to have relatively the same amounts of taxable income, the couple will pay more than twice the tax than what each single person paid in taxes prior to his or her marriage.[77] There is, therefore, a penalty on the act of marrying itself. Couples more likely to incur a marriage penalty are those with two earners with similar incomes, and those with higher combined incomes.[78] Couples are more likely to incur a marriage bonus where there is only one wage earner.[79]

Under 2005's rate schedules[80], if two single cohabiting taxpayers each had a taxable income of $100,000, each taxpayer would have an individual tax liability of $22,506.50 for a total liability for the unmarried couple of $45,013. If the

two single persons decided to and were legally able to marry, on their joint tax return they would instead owe $46,591.50, or an additional $1,578.50, the "marriage penalty/singles' bonus."[81]

While the singles' penalty did not disappear in 1969, it was somewhat alleviated by the adoption of the new rate schedule for single or unmarried taxpayers. So, if a single taxpayer had $200,000 in taxable income in 2005, his or her tax liability would be $52,999 versus $46,591.50 for a married couple filing jointly, resulting in a "singles' penalty/marriage bonus" of $6,407.50—a considerable sum and much more punitive than the marriage penalty in the prior example.[82] As Scott Houser, a tax-code expert and economics professor at California State University in Fresno put it, "[f]ixing the marriage penalty is just going to make the singles penalty worse." [83]

The same tax liability would obtain for this particular single or unmarried taxpayer if he or she were (a) truly single (never married, divorced, or widowed and not a surviving spouse or qualifying widow or widower), (b) a partner in an unmarried relationship, heterosexual or homosexual, (c) merely sharing living quarters and arrangements as roommates often do, or (d) part of a nontraditional extended family that does not fit the definition of "head of household" under the Internal Revenue Code.

Currently, the only legally available way for a particular single taxpayer to "avoid" the harsh single's penalty would be to marry an individual with no taxable income. So, if this particular unmarried taxpayer desired to and was legally able to, and did marry such a person, his or her tax liability would drop from $52,999 to $46,591.50, resulting in a marriage bonus

of $6,407.50 to the married couple (the same amount as the singles' penalty when the taxpayer remained unmarried).

V. CONFLICTS BETWEEN NEW TYPES OF FAMILIES AND THE JOINT RETURN

In light of the growing numbers of never married taxpayers, unmarried heterosexual couples, unmarried (at least for federal tax purposes) homosexual couples, the increasing number of divorced persons and widows and widowers (all of whom may have dependents)[84], the joint return and its rate structure and their underlying theories are no longer appropriate.[85]

There have been numerous unsuccessful constitutional challenges to the filing status categories on the grounds that the classifications discriminate unfairly against unmarried persons.[86] The most recent challenge to the filing status categories as unconstitutionally discriminating against homosexuals unable to marry legally at the time came in *Mueller v. Commissioner*.[87] Mueller failed to file a tax return from 1986 through 1995 as a protest to his being limited to filing a tax return as "single" no matter what his actual relationship status.[88] He challenged the marital classifications in the Internal Revenue Code as discriminatory on equal protection grounds because he and his gay partner were legally denied the sanctions of marriage. The judge advised Mueller that Congress was the more proper forum for determining whether policy considerations warranted narrowing the gap between the tax treatment of married taxpayers and homosexual and other unmarried partners.[89] The Seventh Circuit Court of Appeals affirmed, reiterating its decision in previous cases that the marital classifications in the Code do not violate the Constitution.[90]

In 1996, Mueller did file a tax return that he had completed jointly with his partner, Todd Bates.[91] On the return, Muller listed his name first and Bates' name second, striking out the word "spouse" where it appeared in the label block of the return.[92] Mueller marked "Married Filing Jointly" as their filing status, but struck out the word "Married".[93] Mueller claimed an exemption for a "spouse" on line 6b of the return, and claimed a standard deduction "based upon his claimed filing status of 'filing joint return.'".[94] Mueller also used the married filing jointly tax rate schedule.[95] He had Bates sign the return on the line below his name, but again struck out the word "spouse" in the signature block.[96] If Mueller had been allowed to file a joint return with Bates, they would have benefited from a "marriage bonus" of $1,897 in federal taxes because although Mueller was employed in 1996, Bates was not.[97]

As DOMA had become law in 1996, in 2001, Mueller directly challenged the definition of "marriage" in 1 U.S.C. § 7 as only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or wife, for purposes of federal law, including the income tax filing categories, as unconstitutional on a variety of grounds, including equal protection, due process, separation of church and state, and the prohibition on cruel and unusual punishment.[98]

Mueller met the same fate in Mueller II as in Mueller I. The judge in Mueller II held that DOMA was irrelevant to Mueller's case because no state recognized same-sex marriage or unions of any sort at that time, and consequently, Mueller and Bates were not and could not have been married.[99] Accordingly, DOMA's existence and definition of marriage did not change the law applicable to Mueller's case.[100] Mueller's

martial status was "single" as determined by state law and the court held that the marital classifications in the Code did not violate the Constitution.[101] While more sympathetic to Mueller's arguments than the judge in the first case, the second judge gave Mueller the same advice he had received previously; namely, that Mueller was in the wrong forum and Congress was the more appropriate body to consider Mueller's constitutional claims.[102] Mueller II was affirmed on appeal.[103]

Notwithstanding Mueller I and II, the current focus among couples in same-sex unions is not on income-tax reform *per se*, but rather on continuing legal recognition of their marriages (or unions) both in their own states, as in Vermont, Massachusetts and Connecticut[104], and possibly in other states. Also, gay advocacy groups are focused on the defeat of DOMA based on constitutional grounds[105], but not by way of an income tax issue involving constitutional challenges.[106]

VI. INTERNATIONAL PERSPECTIVES

A somewhat novel approach has been suggested by the Supreme Court albeit not in an income tax situation. In several recent cases involving human rights as well as sexual orientation, the Supreme Court's majority opinion has looked to international law in making its decisions.

In *Roper v. Simmons*[107], Justice Kennedy, held that the Eighth Amendment's prohibition against cruel and unusual punishment categorically bars capital punishment for crimes committed before the age of 18.[108] Part of his analysis rested on the fact that prior to *Roper*, the United States was the only country that still permitted the juvenile death penalty.[109]

In *Lawrence v. Evans*[110], the U.S. Supreme Court struck down Texas' sodomy law on the ground that it violated the

right to liberty guaranteed by the Due Process Clause of the Fourteenth Amendment to the Constitution. In rendering this opinion, the Court specifically referred to the European Court of Human Rights ("ECHR")[111]; and, for the first time, some of the cases the ECHR had previously decided.[112]

In the wake of *Roper* there has been a very public debate about the appropriateness of looking to the logic of foreign courts to help untangle domestic legal questions. While Justice Ruth Bader Ginsburg embraces this practice, stating that the United States judiciary should consider international law more often[113], Justice Scalia (among others) lambastes it, saying that foreigners should not be given a role in helping interpret the Constitution.[114]

Given the increasing rate of globalization[115], and the recent forays by the majority of the Supreme Court in some cases into international law in deciding constitutional issues[116], it might be instructive to examine what other countries have done with their tax filing units and rate structures.

Among the 32 OECD countries (for 2002), the dominant unit of taxation is the individual and not the family.[117] Joint filing is required in seven countries, and is allowed in six.[118] The individual is the required unit in the remaining countries.[119] And, finally, since 1970, seven countries have moved from joint taxation to individual taxation.[120]

As of 2005, Great Britain provides for same-sex civil partnerships and extends tax benefits to these new unions[121]; the Netherlands provides for same-sex marriages for couples and registered partnerships for either same-sex or opposite-sex couples and also extends tax benefits to these new unions; Denmark also provides a registered partnership for same-sex couples as well as tax benefits; Portugal provides for

partnership rights for same- and opposite-sex couples with the extension of tax benefits; France provides a civil solidarity pact for same- and opposite-sex couples with the extension of tax benefits; and Germany provides for registered partnerships for same-sex couples without an extension of tax benefits.[122]

VII. CONCLUSION

Sweeping demographic shifts have occurred during the last fifty years in the United States, especially the decline of the traditional family and the escalation in the number of single persons and nontraditional families. While Vermont, Massachusetts and Connecticut and an ever-increasing number of foreign countries have afforded some form of legal recognition for same-sex unions, including in most cases changes to the tax laws consistent with these legal changes, the federal government has refused to do so since 1996. This inconsistency between some states and the federal government at the very least creates conflicts and risks for same-sex couples in filing their federal income tax returns.

The confluence of these domestic facts alone makes the continued use of the joint return and its rate structure and their underlying theories inappropriate. Combined with the changes abroad and the extremely remote chance of full federal and state recognition of same-sex unions domestically, Congress should eliminate the unfairness of using the marriage unit as the filing unit for our federal income tax system so the United States can remain a competitive force economically in an increasingly global world. The individual unit better comports with the current realities of the American way of life and that of much of the rest of the world.

ENDNOTES

[1]Goodridge v. Dept. of Public Health, 440 Mass. 309 (2003). Except where specificity is required, the term “same-sex union(s)” will be used throughout this paper to refer to all same-sex marriages, civil unions, and any other legal recognition of a same-sex relationship.

[2] In the landmark ruling of *Baker v. State*, 170 Vt. 194 (1999) the court ruled simply: "[T]he state is constitutionally required to extend to same-sex couples the common benefits and protections that flow from marriage under Vermont law" - adding that to do so is, "when all is said and done, a recognition of our common humanity." Id. at 226. As justification for this decision, the court relied on the state Constitution's Common Benefits Clause - specifically citing this passage: "[G]overnment is, or ought to be, instituted for the common benefit, protection, and security of the people, nation, or community, and not for the particular emolument or advantage of any single person, family, or set of persons, who are a part only of that community." Id. at 228. Lawmakers concluded that they would not open marriage to gay and lesbian couples but, rather, establish a parallel system of protections and responsibilities through the Vermont civil union law, which would become effective July 1, 2000. (codified as amended in scattered statutes throughout the Vermont Statutes Annotated).

The Connecticut bill authorizing civil unions between same sex partners, 2005 Connecticut Senate Bill No. 963, was signed into law April 20, 2005, and became effective on October 1, 2005. http://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&bill_num=963&which_year=2005&SUBMIT.x=11&SUBMIT.y=11.

A bill that would have allowed gay couples in Oregon to form civil unions and that also would have given them many of the rights available to married couples, died in Oregon’s Legislature on August 5, 2005 as the Legislative session ended without a joint vote on the bill. Associated Press, *Ore. Governor Pushing for Civil Unions Law*, NY TIMES, April 13, 2005; http://www.hrc.org/Template.cfm?Section=Oregon1&CONTENTID=28279&TEMPLATE=/ContentManagement/ContentDisplay.cfm

[3] On March 14, 2005, Judge Richard A. Kramer of San Francisco County Superior Court, ruling on Judicial Council Coordination Proceeding No.

4365 (which consisted of six coordinated cases sharing a common issue: whether a marriage in California is a union between a man and a woman even though California Family Code section 308.5 states that only a marriage between a man and a woman is valid or recognized in California) ruled that California's Ban on same-sex marriage was unconstitutional. *See also*, Dean E. Murphy, *Judge In California Voids Ban on Same-Sex Marriage*, NY TIMES, March 15, 2005 § A at 16.

California became the first state ever to pass a bill to extend the freedom to marry to same-sex couples in 2005. Unfortunately Republican Gov. Arnold Schwarzenegger vetoed this important legislation. http://www.hrc.org/Template.cfm?Section=California2&CONTENTID=30358&TEMPLATE=/ContentManagement/ContentDisplay.cfm

California, New Jersey, Hawaii and the District of Columbia have official state/district registries for same-sex couples, *available at* http://www.glaad.org/media/resource_kit_detail.php?id=3457&PHPSESSID=960699f92ed3d418e452fea582723ea2#cm (last visited April 12, 2005). *See also*, Anthony C. Infanti, *Tax Protest, "A Homosexual," and Frivolity: A Deconstructionist Meditation*, 24 ST. LOUIS U. PUB. L. REV. 21 at 26 text accompanying note 163 and note 155 and accompanying text (2005) [hereinafter cited as Infanti, Tax Protest].

[4] *E.g.*, *See Wilson v. Ake*, 354 F. Supp. 1298 (M.D. Fla. 2005) where a lesbian couple, who had been legally married in Massachusetts, sued the United States Attorney General and a Florida court clerk, asserting that Florida was required to recognize their marriage, and seeking declaration that the Defense of Marriage Act and a Florida statute withholding recognition for same-sex marriages entered into in Florida or elsewhere were unconstitutional. The district court held that Defense of Marriage Act (*see* note 8 *infra* and accompanying text) did not violate the Full Faith and Credit Clause nor the equal protection or due process guarantees, the right to marry a person of the same sex is not a fundamental right guaranteed by the Due Process Clause, and the Florida statute was constitutional. *Id*. at 11, 13, and 14. *See generally*, Robin Cheryl Miller and Jason Binimow, Annotation, Marriage Between persons of Same Sex—United States and Canadian Cases, 1 A.L.R. Fed. 2d 1 (March 2005) (discussing the case law in the U.S. and Canada on same-sex unions, as well as the Defense of Marriage Act).

---

[5] *Id*.; Joanna Grossman, *Will Non-Resident Same-Sex Couples Be Able to Marry In Massachusetts? The State's Highest Court Considers the Marriage Evasion Law*, FINDLAW'S LEGAL COMMENTARY: LEGAL WRIT, Mar. 01, 2005. Professor Grossman discusses the Massachusetts marriage evasion statute, enacted in 1913, that Governor Mitt Romney had announced his intention to enforce one month before the first same-sex marriage was performed in Massachusetts (which was May 16, 2004). *Id*. The marriage evasion law requires, among other things, that city and town clerks cannot issue a marriage license unless and until they have seen proof, and are satisfied, that an out-of-state applicant is not prohibited from marrying in his home state. *Id*. Eventually, the clerks statewide agreed to comply with the marriage evasion law. *Id*. Subsequently, eight same-sex couples sued for a preliminary injunction against enforcement of the marriage evasion law, which was denied, *Cote-Whitacre v. Department of Public Health*, 18 Mass. L. Rptr 190, 2004 WL 2075557 (Mass. Super. Ct. 2004). Plaintiffs then requested a direct appellate review by Massachusetts' highest court, the Supreme Judicial Court, which request was granted. Final briefs are due in May 2005 and the case will be set for argument sometime thereafter. *Id.*

Professor Grossman argues that regardless of how the Supreme Judicial Court rules, it's time for Massachusetts to get rid of the marriage evasion law, by legislative repeal if necessary. *Id*. She states that for marriage to be meaningful, it must be portable to promote the stability of same-sex marriages. *Id*. For example, if the marriage evasion law is strictly enforced and (a) the Massachusetts married same-sex couple cross state lines, they lose the benefits and protections that their marital status had provided; or (b) one spouse in a Massachusetts same-sex marriage wants to abandon the other (and any children of the relationship) hassle free, the departing spouse need only move to any one of the forty states whose laws expressly prohibit same-sex marriages, in order to be relatively confident that the union will not be recognized and that the obligations created by marriage cannot be enforced. *Id*.

[6] *Id.*

[7] *See* notes 4-6 *supra* and accompanying text.

[8] Pub. L. 104-199, §§ 2(a), 3(a), 110 Stat. 2419 (codified as amended at 1 U.S.C. §7 and 28 U.S.C. §1738C (2005)) [hereinafter cited as DOMA].

---

1 U.S.C §7 (2005) provides:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or wife.

28 U.S.C. §1738C (2005) provides:

> No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or a right or claim arising from such relationship.

[9] Mass. Dept. of Revenue Technical Information Release 04-17, Mass. Tax Issues Associated with Same-Sex Marriage.

[10] *Id.* Although the filing status question is resolved by Massachusetts' Technical Release, note 9 *supra*, the conflict between the federal and Massachusetts income tax laws have produced a myriad of unanswered questions (for example, are Massachusetts same-sex married couples legally allowed to transfer assets to the other spouse estate-tax free when one of them dies?) and additional work (a phantom federal tax return has to be prepared but not filed for the couple as if they were filing married filing jointly and the federal government recognized their marriage, in order to calculate their Massachusetts state income taxes [because in some instances elements of Massachusetts taxation may either derive from federal tax, such as the definition of gross income, or state deductions may be based on a federal counterpart] and to file the actual Massachusetts joint return, and then two individual federal income tax returns must actually be prepared for filing purposes—a total of four tax returns). Kimberly Blanton, *With Marriage, Gay Couples Face Tax Tangles*, BOSTON GLOBE, March 14, 2005, at (Business), A1, *available* at LEXIS, News Library, Bglobe File.

The same headaches and risks faced by Massachusetts same-sex marital partners seem to prevail for partners in Vermont civil unions. For Vermont income tax purposes, civil union partners are treated as if married and must

---

file their Vermont income tax return as either Civil Union Filing Jointly or Civil Union filing separately. However because of the need for federal income tax information on the Vermont income tax return, just as in Massachusetts, the civil union partners must complete a Married Filing Jointly or Married Filing Separately tax return to use for that purposes. Finally, each partner must then complete and file an actual federal return, which under current law, can only be filed as single. http://www.state.vt.us/tax/pdf.word.excel/individual/civilunions.pdf

Connecticut's law does not yet speak of the filing technicalities for civil union partners. It does, however, seem to indicate that at the least partners in a civil union will be treated the same as if they were legally married for withholding tax purposes. http://www.ct.gov/drs/cwp/view.asp?a=1479&q=307384

For purposes of this paper, tax returns filed as either married filing jointly or single will be the only ones discussed. All other filing status categories are beyond the scope of this paper.

See note 12 *infra* and accompanying text for the IRS' definition of "married". *See* part IV *infra* for the historical development of the jointly filed return category.

The terms "single" and "unmarried" are used interchangeably throughout this paper. A single or unmarried taxpayer includes a taxpayer who is (a) truly single (never married, divorced, or widowed and not a surviving spouse or qualifying widow or widower), (b) a partner in an unmarried relationship, heterosexual or homosexual, (c) merely sharing living quarters and arrangements as roommates often do, or (d) part of a nontraditional extended family that does not fit the definition of "head of household" under the Internal Revenue Code [hereinafter cited as IRC]. All references to IRC are to the Internal Revene Code of 1986, as amended.

[11] *Supra* note 8.

[12] *See* 1 U.S.C.§7 *supra* note 8. *See also*, Letter from the Internal Revenue Service to Eugene A. Delgaudio, President, Public Advocate of the United States, Inc. (June 14, 2004), ["The law is clear on this issue, and we point out the federal definition of marriage when explaining 'filing status' in IRS Publications 17, 'Your Federal Income Tax,' and 501, 'Exemptions,

Standard Deduction, and Filing Information.' In both publications, we introduce the subject of marital status with this paragraph: 'In general, your filing status on whether you are considered unmarried or married. A marriage means only a legal union between a man and a woman as husband and wife."] available at http://www.publicadvocateusa.org/news/article.php?article=121 (last visited April 9, 2005). For reporting on the letter, see Allen Kenny, *IRS: Joint Filing Not Allowed for Same-Sex Married Couples*, 103 TAX NOTES 1466 (2004) all cited in Infanti, Tax Protest at 24 note 2 and accompanying text.

[13] IRC §§6061-6063, 6065; Boris I. Bittker, Martin J. McMahon, & Lawrence A. Zelenak, Federal Income Taxation Of Individuals at ¶44.01[6] (Warren Gorham & Lamont Third Edition 2002) [hereinafter Bittker, Federal Income Taxation]. *See also*, E.J. Graff, *Marrying Outside the Box: What happens when same-sex spouses face the I.R.S.?*, N.Y. TIMES, April 10, 2005 §6 (Magazine) at 22 [hereinafter cited as Marrying Outside the Box].

[14] The IRS seems relatively nonplussed by this issue: in Marrying Outside the Box, *supra* note 13 at 24, Eric Smith, an I.R. S. spokesman, stated: "Historically, filing status has not been a primary focus of our compliance efforts. The largest focus we have is on tax abuse, abusive tax shelters, that sort of thing." It should be noted that there is no place on the 1040 form to declare whether you are male or female since that's irrelevant to how much you owe. *Id*.

[15] Some of the most obvious are as follows: (1) the joint return rate schedule IRC § 1(f)(8)(B) provides that from January 1, 2004 through December 31,2010 the upper limit of the 15 percent rate bracket for married couples filing joint returns is 200 percent of the upper limit of the 15 percent rate bracket for unmarried taxpayers; (2) an exemption for taxpayer and for his or her spouse on a joint return IRC § 151(b); (3) the standard deduction on a joint return is twice that of a single taxpayer § IRC § 63(c)(2) again from January 1, 2004 through December 31, 2010; (4) IRC § 1041's tax-free transfers between spouses; (5) IRC §121's $500,000 exclusion of gain from the sale of a principal residence from the gross income of a married couple filing a joint return (other taxpayers are entitled to only a $250,000 exclusion). Married taxpayers, however, are not always treated so favorably nor so consistently throughout the Code. For example, the capital loss limitation of $3,000 per tax year is the same for married taxpayers and individuals, IRC §1211. *See* Philip J. Harmelink, *Marital*

Status Tax Discrimination After Tax Reform: Proposals to Resolve the Penalty/Bonus Issues, 26 WILLIAMETTE L. REV. 593 at 603-15 (1990) for a discussion of various treatments. His list is extensive, but is neither current nor comprehensive. It is very useful, however, for demonstrating that the marital unit is treated inconsistently throughout the Code by delineating six different categories that are related to marital status: (1) provisions treating spouses separately, (2) provisions giving married couples twice the benefits given single persons, (3) provisions giving married couples the same benefits given single persons, (4) provisions giving married couples greater benefits than single persons, but less than twice the benefits given single persons, (5) provisions subject to floors and phaseouts,and (6)miscellaneous provisions and biasing factors. *Id*. *See also* Marjorie E.Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63, at 100 and notes 113-115 and accompanying text (1993) [hereinafter cited as Kornhauser, Love, Money, & the IRS].

[16] Kornhauser, Love, Money & the IRS at 101.

[17] Kornhauser, Love, Money & the IRS at 101-02 and text accompanying note 122. Professor Kornhauser cites a 1947 Treasury Department report entitled *The Tax Treatment of Family Income*, which made no recommendations as to how to respond to certain perceived inadequacies in the federal tax system. It stated that it would merely "examine alternative methods of correcting discriminations which arise in the treatment of family income under present Federal income tax law." She also cites Toni Robinson & Mary Moers Wenig, *Marry in Haste, Repent at Tax Time: Marital Status as a Tax Determinant*, 8 VA. TAX REV. 773, 773-79 (1989) who stated that income splitting was adopted not out of ability-to-pay considerations, but out of necessity to stem the flight to community property law. But Professors Robinson and Wenig did recognize that the 1948 change was "tax reform" to the extent that it reduced taxes for middle and upper class couples in common-law-states. Kornhauser, Love, Money & the IRS at 101-102 note 122. *See* part II *infra*.

[18] Kornhauser, Love, Money, & the IRS at 101-102.

[19] *Id*. at 103.

[20] U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, tbl. 578 (2004-2005). It should be noted that data for 1994 and subsequent years are not strictly comparable to prior years because of a

major redesign of the survey questionnaire and collection methodology. *Id*. at tbl 569 note 2. [hereinafter cited as Stat. Abstract]. The comparable 1993 datum is that 59.4% of married women participated in the workforce.

[21] Michelle Conlin, *UnMarried America*, BUSINESS WEEK, March 20, 2004, at 106, 108 [hereinafter cited as Conlin, UnMarried America]. The "household" is the major unit of classification in the U.S. Census and it consists of "all persons who occupy a housing unit. People not living in households are classified as living in group quarters." Stat. Abstract at A-2 (2000).

[22] Conlin, UnMarried America at 109.

[23] *Id.* at 108.

[24] *Id*.

[25] Conlin, UnMarried America at 109. One can only assume that with the legalization of same-sex unions in Vermont, Massachusetts, and Connecticut (as well as possible legalization in other states *see* notes 2-3 *supra* and accompanying text) these numbers may accelerate.

[26] *Id*. at 108 and 110.

[27] *Id.*

[28] *Id*. at 109.

[29] *Id.* at 110. This phenomenon is consistent with the finding that a record number of children are born to single parents, text accompanying note 22 *supra*.

[30] *Id.*

[31] *Id*. at 110 and 114.

[32] *See* note 17 *supra* and accompanying text.

[33] Boris I.Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, at 1400 (1975) [hereinafter cited as Bittker, Taxation and the Family].

---

[34] *Id*.

[35] *Id*.

[36] *Id*.

[37] *Id*. If each spouse had $60,000 of taxable income and the tax rate was 10% on the first $30,000 and 20% on the next $60,000, and 30% on the next $120,000 each spouse's tax liability would be $9,000 for a total tax liability of $18,000 for the married couple who filed separately ([$30,000 X 10%] + [$30,000 X 20%]) X 2. If each spouse's taxable income were combined on one jointly filed tax return, the couple's federal tax liability income would be $24,000 ([$30,000 X 10%] + [$60,000 X 20%] + [$30,000 X 30%]) or $6,000 more in federal tax liability because the couple was not able to take advantage of the "income-splitting" effects of each spouse filing individually and the benefits of the progressive rate schedule.

Each Spouse Filed Own Return			Spouses Filed Joint Return		
Spouse 1	$30,000 X 10% =	$3,000	Spouse 1	$30,000 X 10% =	3,000
	30,000 X 20% =	6,000		30,000 X 20% =	6,000
Spouse 2	30,000 X 10% =	3,000	Spouse 2	30,000 X 20% =	6,000
	30,000 X 20% =	6,000		30,000 X 30%=	9,000
Total TI	120,000 Total Tax	18,000	Total TI	120,000 Total Tax	24,000
Additional Tax					6,000

The benefits of each spouse filing his or her own tax return were obvious: a $6,000 tax savings, due to the ability of each spouse to compute his or her tax starting at the lowest tax rate whereas if the married couple elected to file jointly and combine both incomes on one jointly filed tax return, the second spouse's $60,000 of taxable income begins to be taxed at 20% (the first $30,000 of it) and not at 10% as for the separately filing spouses, for an additional tax of $3,000. And, the last $30,000 of taxable income of the second spouse in the couple filing the joint return is taxed at 30%, not 20% as for the separately filing couple, for an additional tax of $3,000 on that layer of income; a total additional tax of $6,000 for the jointly filing couple.

See note 81 *infra* and accompanying text for a discussion of the mandatory effect of the progressive tax rate structure on the second earner's taxable income for the married filing jointly category under current federal tax law.

[38] *Id*.

[39] Patricia A. Cain, *The Story of Earl* in TAX STORIES 275, at 279 (Paul L. Caron ed. 2003) [hereinafter cited as Cain, The Story of Earl].

[40] Bittker, *Federal Income Taxation and the Family* at 1400.

[41] *Lucas v. Earl*, 281 U.S. 111 at 113 (March 1930).

[42] 281 U.S. 111 (1930).

[43] *Id*. at 114.

[44] And the famous fruit and tree metaphor: "…we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id*.

[45] Bittker, Taxation and the Family at 1401. There is disagreement in the literature as to whether the Supreme Court in *Lucas v. Earl* was trying to protect the progressive rate schedule. *Compare* Bittker, Federal Income Taxation and the Family at 1402-03 ("the common notion that the principle of *Lucas v. Earl*, as applied to married couples was an essential buttress to the progressive rate schedule is fallacious.") with Cain, The Story of Earl at 279 ("[t]he government's concern in Earl, never explicitly mentioned by Holmes, was protection of the progressive rate structure. If an agreement to shift income results in the undermining of progressivity, that agreement should be ignored by the tax collector regardless of the taxpayer's innocent non-tax avoidance motives"). *See* note 37 *supra* and accompanying example for the benefits of splitting income, filing separately and the concomitant advantages of the progressive rate schedule.

[46] Kornhauser, Love, Marriage, & the IRS at 73.

[47] *Poe v. Seaborn*, 282 U.S. 101 at 117 (November 1930). In *Poe*, the Court explained that although California also had a community property regime, a California wife's interest in community property amounts to a mere expectancy continent on her husband's death and does not rise to level of a present interest. This was also the position of the Attorney General and the Treasury Department in denying husbands and wives the privilege of making separate returns of one-half of the community income in California, but according that privilege to residents of other community property states.

Poe v. Seaborn, 282 U.S. 101 at 113-14 and notes 3 and 4 and accompanying text. Hence, the different results in *Lucas v. Earl* and *Poe v. Seaborn*. The other community property states which gave the wife a "vested interest" in one-half of all community income, resulting in each spouse reporting and paying tax separately on his or her half share, were Arizona, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Bittker, Taxation and the Family at 1406.

[48] Kornhauser, Love, Marriage, & the IRS at 80-91 (based on empirical studies, Professor Kornhauser found that control of the money generally still resides with the earner; thus she argues that the owner should be the taxable unit, not the married couple); *but see* Cain, The Story of Earl 276-79 (the earner may not be entitled to the income, for various reasons, [*e.g.*,junior associate in a law firm brings in earnings far in excess of his or her salary] and Professor Cain states that we do not tax the earner in those instances).

It is interesting to pause here for a moment and reflect upon what the Earls tried to accomplish with their marital contract in 1901: they established a marital regime of equal ownership and equal control of their joint income such that their contract equalized each spouse's financial position within the marital unit. Bittker, Taxation and the Family at 1402. If the Earl's marital contract had been upheld by the Supreme Court, it would have not only provided for income splitting of the Mr. Earl's earned income, but it would have done so in a way that would have required the Earls to equalize their ownership of the income *inter se* (and for subsequent taxpayers as well). *Id*. This is a far cry better than what Congress achieved in 1948 when it enacted the married filing jointly rate structure and pure income splitting between married taxpayers. *Id***.**

[49] 282 U.S. 101 (November 1930).

[50] *Id*. at 109.

[51] *Id*

[52] *Id.*

[53] Bittker, Federal Income Taxation ¶ 35.01; Bittker, *Federal Income Taxation and the Family* at 1407.

[54] Bittker, Federal Income Taxation ¶ 35.01(emphasis added) citing *Poe v. Seaborn*, 282 U.S. 101, 117 (1930). *See also* note 47 *supra* and accompanying text.

[55] Bittker, *Federal Income Taxation and the Family* at 1408.

[56] *Id. See e.g*. of Adam and Anna and Betty and Bob part IV *infra*. So, in community property states, marriage usually reduced, and divorce increased, a couple's federal income taxes: marriage was not a tax-neutral event.

[57] Bittker, Federal Income Taxation ¶ 35.01.

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] 323 U.S. 44 (1944).

[63] *Id*. at 46 (1944); Bittker, Federal Income Taxation ¶ 35.02

[64] *Commissioner v. Harmon*, 323 U.S. 44, 46; Bittker, Federal Income Taxation ¶ 35.02.

[65] Bittker, Federal Income Taxation ¶ 35.02.

[66] *Id.*

[67] *Id.*

[68] Bittker, *Federal Income Taxation and the Family* at 1412-13. With the tax disparity between community property and common-law property largely eliminated, the new community property states lost their taste for Spanish law and repealed their statutes. Bittker, Federal Income Taxation at ¶ 35.02. Thus, each spouse was presumed to earn one-half of the couple's taxable income and tax was computed as if each spouse filed individually.

Accordingly, each couple was given the advantages of income-splitting and the progressive rate schedule. *See* note 37 *supra* and accompanying text.

[69] *Id*. at 1413.

[70] *Id.* In 1940, the Supreme Court, in *Helvering v. Horst*, 311 U.S. 112 (1940) extended the assignment of income doctrine to income from property. Taxpayers with investment income could shift the tax liability for that income to their spouses or children as long as they were willing to give up ownership of the underlying income-producing property (securities, bank account, rental real estate, etc.). Bittker, *Federal Income Taxation and the Family* at 1401. Consequently there was a distinction between the taxation of earned income and investment income from 1940 until 1948 when Congress established the joint filing structure and allowed for income splitting between spouses. *Id*. Professor Bittker notes that even though most income and deduction items were aggregated as a result of the enactment of the 1948 joint return, many tax provisions continued to treat husband and wife as separate individuals even if they filed a joint return. Id. at 1414-1416. *See* note 15 *supra* and accompanying text.

[71]

Debbie's Tax			Spouses' Tax		
Taxable Income	Tax		Taxable Income	Tax	Add'l Tax
$10,000 X 0% =	$ 0	Spouse 1	$10,000 X 0% =	$ 0	
20,000 X 15% =	3,000		15,000 X 15% =	2,250	$ 750
20,000 X 30% =	6,000	Spouse 2	10,000 X 0% =	0	
			15,000 X 15% =	2,250	3,750
50,000	9,000		50,000	4,500	
Additonal Tax: Singles' Penalty/Marriage Bonus:					$4,500

[72] For Adam and Anna, who had $50,000 of taxable income all earned by Adam, there would have been a marriage bonus as well because under the 1948 scheme, Adam would have had a $9,000 tax liability if he had been single like Debbie. Adam's marriage to Anna gave Adam the opportunity of splitting his income with her under the joint return regime and having the same tax liability, $4,500, as Betty and Bob, who each actually had $25,000 of taxable income.

As explained by Dorothy Brown: A marriage bonus occurs whenever a couple pays lower federal income taxes as a result of marriage than they would pay if they remained single and filed individual returns. Marriage

bonuses are the greatest where there is only one wage earner. Dorothy A. Brown, *The Marriage Bonus/Penalty in Black and White*, 65 U. CIN. L. REV. 787, 787 (1997).

[73] Bittker, Federal Income Taxation at ¶ 44.02[5]. Congress responded to the third of these complaints in 1951 and 1954 by enacting the special rate schedule for heads of households and allowing surviving spouses to use the joint return rates for two years following the deceased spouse's death. *Id.* For a further discussion of the validity of the economic justifications for the disparity in taxation between married couples and single persons, *see* Bittker, Federal Income Taxation and the Family at 1420-26; Kornhauser, Love, Money, & the IRS at 96-100.

[74] Bittker, Federal Income Taxation at ¶ 44.02[5]. Although in intervening years, the ceiling has changed on the percentage by which a single taxpayer's tax liability on a particular amount of taxable income may exceed the tax liability of a married couple filing jointly with the same taxable income, the principles of the 1969 relationship of the rate schedules are still manifest in IRC § 1. *Id.*

[75] Again, as explained by Dorothy Brown: A marriage penalty occurs whenever a couple pays higher federal income taxes as a result of their marriage than they would pay if they remained single and filed individual returns. Marriage penalties are the greatest where there are two wage earners. Dorothy A. Brown, *The Marriage Bonus/Penalty in Black and White*, 65 U. CIN. L. REV. 787, 787 (1997).

[76] *Id.* Pub. L. 108-311, 118 Stat. 1144 (2004), Working Families Tax Relief Act of 2004 [hereinafter cited as WFTRA 2004] eliminated the marriage penalties in the standard deduction and in the 15 percent bracket for tax years beginning after December 31, 2003 for taxpayers filing joint returns. Thus, for tax years beginning on January 1, 2004 and through December 31, 2010, the joint return standard deduction is 200 percent of the standard deduction for unmarried taxpayers, IRC § 63(c)(2),and the upper limit of the 15 percent rate bracket for married couples filing joint returns is 200 percent of the upper limit of the 15 percent rate bracket for unmarried taxpayers, IRC § 1(f)(8)(B).

[77] (Except for 2004 through 2010 for the 15 percent bracket as explained in note 76 *supra*). Bittker, Federal Income Taxation at ¶ 44.02[5]. And because Congress recognized that these married taxpayers would probably

notice this phenomenon, it barred married taxpayers from filing separate returns using the new singles rate structure. Instead, married taxpayers who wish to file separate tax returns are subject to a special married filing separately rate schedule, IRC § 1(d). *Id.*

[78] *See* notes 72 and 75 *supra* and accompanying text. The penalty results from pursuing three policies: (1) equal taxes for all equal-income married couples; (2) a smaller differential between single and married persons than was provided by "pure" income splitting from 1948 to 1969; and (3) a progressive rate structure. Bittker, Federal Income Taxation at ¶ 44.02[5]. It should be noted that these objectives cannot be achieved simultaneously. *Id.*

[79] *Id.* 51 percent of married couples received a marriage bonus of $1,300 and 42 percent paid a marriage penalty of $1,400, and 6 percent were unaffected. Under the basic measure of the marriage penalty, couples paid a total of about $4 billion less in taxes than they would have if they were required to file as individuals. Congressional Budget Office, *For Better or Worse: Marriage and the Federal Income Tax* at 29-30 (1997) [hereinafter cited as CBO Study].

[80] Thomas R. Pope, Kenneth E. Anderson, John L. Kramer, Prentice Hall's Federal Taxation 2006 Comprehensive at front right inside cover (Pearson/Prentice Hall 2006).

[81] In this particular example, the "second earner's" taxable income does not have the advantage he or she had when single of having the first dollar of taxable income taxed at 10%; instead the first dollar of the second earner's taxable income is taxed at the marginal rate that applied to the last dollar of the first earner's income. In this case, on the joint rate schedule, $100,000 of taxable income begins to be taxed at 25%. In addition, once total taxable income exceeds $182,800 on the joint return (as it does here), the marginal tax rate increases to 33%.

[82] But, if this particular unmarried taxpayer desired to and was legally able to marry, and did so, his or her tax liability would drop from $52,999 to $46,591.50, resulting in a marriage bonus of $6,407.50, to the married couple (the same amount as the singles' penalty when the taxpayer remained unmarried).

[83] Conlin, UnMarried America at 108. For slightly more than half of all spouses, marriage actually slashes their tax liability, CBO Study at 29-30. Conlin, UnMarried America at 108. That means, for example, that highly-salaried executives with stay-at-home wives get subsidies that single working mothers do not. *Id.;* Kornhauser, Love, Marriage & the IRS note 143 and accompanying text. In effect, there is a bonus to high-salaried executives with stay-at-home wives and over time, a wealth shift to high-income, one-earner married taxpayers. *Id.*

[84] *See* text accompanying notes 21-31 *supra*.

[85] One of the problems with reform with respect to the income tax treatment of marriage is that some group of taxpayers will have a plausible complaint of unfair treatment, regardless of which approach Congress chooses. Bittker, Federal Income Taxation at ¶ 44.02[5].

[86] *See also*, *Estate of Armstrong v. Commisioner*, 119 T.C. 220 at 37-38 for citations to multiple cases regarding the constitutionality of the marital classifications.

[87] 79 T.C.M. 1887 (2000) [hereinafter Mueller I] cited in Infanti, Tax Protest at 9-13.

[88] Infanti, Tax Protest at 10.

[89] *Mueller*, 79 T.C.M. (CCH) at 1890 cited in Infanti, Tax Protest at 13.

[90] Mueller v. Commissioner, 2001-1 U.S.T.C. (CCH) ¶ 50,390 (2001) cited in Infanti, Tax Protest at 13.

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.*

---

[96] *Id.*

[97] Infanti, Tax Protest at 14 and note 72 *supra* and accompanying text.

[98] Infanti, Tax Protest at 14.

[99] 82 T.C.M. (CCH) 764 (hereinafter Mueller II) cited in Infanti, Tax Protest at 13-16.

[100] *Id.*

[101] *Id.*

[102] *Id*. at 14-15.

[103] *Mueller v. Commissioner*, 2002-2 U.S.T.C. ¶ 50,505 (2002).

[104] *See* notes 1-3 *supra* and accompanying text.

[105] *See*, e.g., *Wilson v. Ake*, note 4 *supra.* The right injustice might be a widowed mom denied her dead spouse's Social Security benefits or a widower refused the federal benefits set aside for public-safety officers' families. Marrying Outside the Box at 22.

[106] *Id.*

[107] 125 S.Ct. 1183 (March 1, 2005).

[108] Linda Greenhouse, *Supreme Court, 5-4, Forbids Execution in Juvenile Crime*, NY TIMES, § A at 6, March 2, 2005.

[109] *Id.*

[110] 539 U.S. 558, 552 (2004).

[111] The EHCR began "the development of international human rights law in the area of gay and lesbian sexuality." Infanti, Tax Protest text accompanying note 120, citing Kristen L. Walker, *Evolving Human Rights Norms Around Sexuality*, 6 ILSA J. INT'L & COMP. L. 343, 344 (2000).

[112] Infanti, Tax Protest at 24.

---

[113] Anne. E. Kornblut, *Justice Ginsburg Backs Value of Foreign Law*, NY TIMES, § A at 10, April 2, 2005.

[114] *Id.*

[115] Thomas L. Friedman, *It's a Flat World, After All*, NY TIMES, § 5 (Magazine) 33-37 (April 3, 2005).

[116] And the fact as Justice Ginsberg also stated that "[e]ven more so today, the United States is subject to the scrutiny of a candid world…[w]hat the United States does, for good or for ill, continues to be watched by the international community, in particular by organizations concerned with the advancement of the rule of law and respect for human dignity." Anne. E. Kornblut, *Justice Ginsburg Backs Value of Foreign Law*, NY TIMES, § A at 10, April 2, 2005.

[117] James Alm, *Thinking About the "Marriage Penalty*, PRESIDENT'S ADVISORY PANEL OF FEDERAL TAX REFORM, March 23, 2005 available at http://www.taxreformpanel.gov/meetings/docs/alm.ppt (last viewed April 2, 2005).

[118] *Id.*

[119] *Id.*

[120] *Id.*

[121] Julian Knight, Same-sex couples enjoy tax boost, BBC News, December 2, 2005 at http://news.bbc.co.uk/1/hi/business/4491620.stm

[122] Sarah Lyall, In Europe, Lovers Now Propose: Marry Me, a Little: Legal Alternatives to Wedding Vows, NY Times, § A at 3 February 15, 2004. *See also* Gay Marriage Around the Globe, BBC News, December 22, 2005 at http://news.bbc.co.uk/1/hi/world/americas/4081999.stm which states that in addition to the countries already mentioned herein Canada, Spain, Norway, Sweden, Iceland, Finland, Belgium, Luxemborg, Argentina, and New Zealand provide some form of legal recognition of same-sex unions—ranging from the full benefits of legalized marriage to the status of a registered partnership.

FAMILY LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES AS ESTATE PLANNING DEVICES

by

Richard J. Kraus*
Roy J. Girasa**

INTRODUCTION

A family limited partnership ("FLP") or a family limited liability company ("FLLC") may produce significant estate and gift tax savings, if properly formed and operated. A great deal of preparation and caution, however, must be practiced to protect the client.

This article proposes to describe formation of the entities, the desirability of minority and marketability discounts available and to observe a number of tax difficulties presented because of Internal Revenue Code ("Code") proscriptions[1] .

FORMATION OF THE ENTITIES: PLANNING

The Internal Revenue Code clearly indicates that an FLP or FLLC may not be formed exclusively for tax saving purposes if the entities seek to escape income tax liability[2]. The Internal Revenue Service has applied the same rationale to

---

*Professor of Law, Lubin School of Business, Pace University, New York.

** Professor of Law, Lubin School of Business, Pace University, New York.

attempt to circumvent liability for estate and gift taxes. The Service argues that section 2036(a) of the Code will, in certain circumstances, compute FLP or FLLC assets as part of the decedent transferor's estate[3]. That Section provides

> (a) General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration for money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death --
> (1) the possession or enjoyment of, or the right to the income from, the property,
> or
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

In *Estate of Albert Strangi, Deceased, Rosalie Gulig, Independent Executrix, v. Commissioner of Internal Revenue*[4], the United States Tax Court decided that the decedent's attorney-in-fact, Micheal J. Gulig, improperly used a Texas family limited partnership and corporation through forms supplied by a vendor to attempt to protect the assets of Mr. Strangi from creditors, to plan his estate and to limit tax liability. The court reasoned that the Code requires that all of

Albert Strangi's assets be included in his estate for gift or estate tax purposes.

> The record reveals no part of the transferred property was exempt from the rights or enjoyment retained by the decedent. The relevant documents make no distinction among the various assets contributed, nor does the evidence reflect that Mr. Gulig looked to particular assets in determining whether amounts should be distributed. The preponderance of the evidence therefore establishes that the full value of the transferred assets is includable under section 2036 (a)[5].

A number of precautions, however, will assist the practitioner in the formation of the FLP or FLLC in order to design an entity to meet family needs and to avoid the results of the *Strangi* decision.

The partnership or company should never be formed exclusively for tax saving purposes; all interested family members should meet with the practitioner to examine the reasons for forming an entity. These reasons include:

1. The protection of assets from claims of creditors so that those creditors may obtain only assignee's rights;
2. Divorce distribution of entity interests which are passive and subject to transfer restriction;
3. Continued control of the assets despite the fact that children now possess the interests of a limited partner;

4. Protection of gifts through the use of fractional interests rather than outright gifts;
5. Insurance that interests remain in the family because of their lack of marketability and minority status;
6. Encouragement of family communications concerning business matters;
7. Avoidance of out-of-state probate of assets includable as personal property in the entity;
8. Mandate of alternate dispute resolution procedures in the documents to prevent public law suits among interest owners;
9. Assurance of management continuity;
10. Utilization of the larger business entity to increase the value of family assets.

The practitioner should ensure that the documents strictly comply with statutory requirements and that assets be re-titled and not be co-mingled with other assets.

The practitioner also should advise the family to hold regular business meetings, fully examine financial reports, prepare FLP or FLLC tax returns and issue income statements to FLP partners or to FLLC members[6].

FORMATION OF THE ENTITIES: MECHANICS

New York and a number of other jurisdictions require similar procedures to form an FLP and a FLLC. In particular, a Certificate of Limited Partnership for an FLP and Articles of Organization for a Limited Liability Company must be filed with the Secretary of State or other state of authority, indicating the name of the entity, its principal place of business within the state, an identification of each general partner for an FLP or whether the FLLC is to be managed by members or managers, and the designation of the Secretary of State or other

public official as agent for service of process[7].The entities may be organized for any lawful business purpose, but do not require that the business operate for a profit[8].

Accompanying documents, furthermore, should describe the fact that more than one transferor has made a contribution to the FLP or FLLC. Ideally, a mother, father and children should make contributions even if the parents give to the child the funds needed to make the FLP or FLLC contribution[9]. After the contribution is made, a period of approximately six months should elapse before gifts of interests in the FLP or FLLC are assigned to a family donee[10].

The practitioner, finally, must carefully draft the partnership or operating agreement: an absolute prohibition on transfer should never be indicated but a right of first refusal will protect family members and at the same time clearly indicate that the gifted interest qualified as a gift of the present interest; the fiduciary duties of general partners or managers should be clearly stated and not limited; distributions from net available cash in accordance with percentage interests should be mandated; liquidation and dissolution rights should be carefully circumscribed so as not to reside in any one individual or group of individuals; gifts should clearly be those of an assignee interest rather than an interest in the entity itself[11].

MINORITY AND MARKETABILITY DISCOUNTS: RESULTS OF PROPER PLANNING

A minority interest in a business entity is obviously worth less than a controlling share. The minority owner cannot solely elect general partners or managers, nor force the liquidation of an entity. The hypothetical buyer proposed by the Code, therefore, will not pay full value for the investment.

The Tax Court has permitted lack of control or minority discounts as a matter of course[12]. The Court has similarly permitted lack of marketability discounts because limited interests are not readily marketable[13]. If the practitioner strictly follows formation procedures and reminds clients to conduct business in the manner described in the partnership or company agreement, then these discounts will be available to the owners and members of an FLP or FLLC.

Several cases illustrate the application of discounts to reflect the true economic value of the interest being transferred at the date of death of the decedent. *Charles T. McCord and Mary S. McCord, Donors v. Commissioner of Internal Revenue*[14] indicates that discounts may be allowed not only for minority and marketability purposes but also because an interest rather than a share is transferred. On June 30, 1995 Charles T. McCord, Jr., Mary S. McCord, his wife, and their four children- Charles III, Michael, Frederick and Stephen formed a Texas limited partnership. This FLP contained the children as general partners, the parents as class A limited partners, and the parents and a separate partnership formed by the children as class B limited partners. The assets of the FLP included stocks, bonds, real estate, and oil and gas investments among other business interests. 65 percent of the holdings were marketable securities, 30 percent consisted of real estate limited partnerships and the remaining 5 percent included the oil and gas investments. The limited partnership agreement indicated that the termination date of the FLP was December 31, 2025 unless sooner terminated by the agreement of the two classes of shareholders.

The contribution of each of the parties occurred in accord with the following classification:

Class and Contributor Interest	Contribution	Percentage
Class A Limited Partners:		
Mr. McCord	$10,000	none
Mrs. McCord	10,000	none
General Partners:		
Charles III	40,000	0.26787417
Michael	40,000	0.26787417
Frederick	40,000	0.26787417
Stephen	40,000	0.26787417
Class B Limited Partners:		
Mr. McCord	6,147,192	41.16684918
Mrs. McCord	6,147,192	41.16684918
McCord Brothers	2,478,000	16.59480496
Total	$14,952,384	100.0

The agreement, furthermore, indicated that a partner may assign a partnership interest to certain permitted assignees including family members and charitable organizations as well as to assignees other than a permitted assignee with the consent of the other partners. The agreement explicitly provided that, regardless of the identity of an assignee, no such party may obtain the status of a partner without unanimous consent of all of the FLP partners.

On November 20, 1995 an assignment was made to the charitable Southfield School Foundation. This transfer included an assignment of a class A partnership interest and admission of the foundation as a class A limited partner with the consent of all the FLP partners. This assignment was of course tax exempt.

On January 12, 1996 further assignments occurred. Class B limited partnership interests were assigned to two other charities-the Communities Foundation of Texas, Inc. and Shreveport Symphony, Inc.-and to four trusts created for the benefit of the McCord children. These assignments contained no language of admission of the assignees as partners of the partnership. The transfers, therefore, were mere assignments rather than conveyances of partnership rights and interests. The assignments to the two charities were once again tax exempt. The assignments to the children's trusts, however, would be subject to gift and estate tax, though a discount would be allowed for minority and marketability purposes. The Tax Court acknowledged additionally that a mere assignee's interest produces an additional allowance for discount.

Estate of Weinberg v. Commissioner[15] describes interests in the Hill House FLP which owned and operated an apartment complex. The complex contained an eleven story building with one hundred and eighty-eight apartment units, an office suite, an underground parking garage, and a swimming pool. Only three of the units in the complex were not rented at the time of the decedent's death. A marital trust for the decedent owned a 25.235% interest in the Hill House FLP. The decedent had a general power of appointment over this interest at the time of her death. She exercised this power of appointment in her will by indicating that the assets be distributed to her trustees in accord with the provisions of a November 2, 1984 inter-vivos trust, or in favor of her executors if the trust no longer existed at the time of her death.

Both the IRS and the executors of the estate agreed that the marketability and minority interest discounts should apply to the decedent's share in the FLP. The Tax Court, however, disagreed with both the petitioner's expert and the respondent's expert in computing the value of that share. The Court

computed the value of the interest by combining a 25% net asset value and a 75% capitalization of earnings method value to determine that the fair market value of the limited partnership interest. The minority capitalization value was $1,333,292.55, the minority net asset value was $303,770.75. The total value of $1,637,063.30 less a marketability discount of twenty percent interest was worth $1,309,658.65.

Peracchio v. Commissioner[16] illustrates that FLP assets which consist of money market funds and marketable securities will produce varying minority interest and marketability discounts. At the time of the decedent's death, the assets which the decedent had contributed to the family limited partnership consisted of the following:

Asset Type	**Fair Market Value**	**Percentage**
Cash & money market funds	$ 883,622	44.0
U.S. Government bond funds	7,988	0.4
State and local bonds	41,750	2.1
National Muni bond funds	101,145	5.0
Domestic equities	877,179	43.6
Foreign equities	98,686	4.9
Total	$ 2,010,370	100.0

The Tax Court determined that the nature of the assets would not greatly affect minority interest value so that the discount permitted was a mere 6-percent. The Court, however,

indicated that an interest in an FLP would seriously affect marketability so that the discount permitted for lack of marketability was 25-percent.

ESTATE TAX DIFFICULTIES: INTERNAL REVENUE CODE SECTION 2036(a)

Two recent United States 5th Circuit Court of Appeals decisions highlight the tax advantages available to FLPs and FLLCs. The cases concentrate upon the two impediments to estate tax reduction present in Internal Revenue Code Section 2036(a): the transfer of property to the family entity must be a bona fide sale for an adequate consideration, and the donor may not retain an interest in the property transferred. At least one of these two cases also refers to the additional diminution that an assignee's interest, as opposed to a partnership interest, would have upon valuation of the property transferred for estate tax purposes.

Bona Fide Sale for an Adequate Consideration: Kimbell

On May 20, 2004 Case No. 03-10529 *David A. Kimbell, Sr., Independent Executor Under the Will of Ruth A. Kimbell, Deceased v. United States of America* was filed with the Clerk of the Court for the United States Court of Appeals, 5th Circuit.[17] The Court in that case concluded that Code Section 2036(a) does not prevent family members from entering a bona fide transaction in which a transfer of assets may occur in return for pro rata FLLC and FLP interests. The decedent, Ruth A. Kimbell, was 96 years of age at her death on March 25, 1998. In 1991 Mrs. Kimbell, in consultation with her son, the present Executor of her estate, established a living revocable trust administered both by herself and her son as co-Trustees. In January 1998, a few months before her death, David Kimbell and his wife formed an FLLC with the Trust as a co-member. The Trust contributed $20,000 for a 50%

interest: Mr. Kimbell and his wife each contributed $10,000 for a 25% interest apiece. David Kimbell solely managed the FLLC.

Later in January 1998, the Trust and the FLLC formed an FLP. The Trust transferred approximately $2,500,000 in cash, oil and gas working and royalty interests and other assets for a 99% pro rata limited partner interest. The FLLC transferred approximately $25,000 in cash for a 1% pro rata general partner interest.

The entity creations were well planned. The FLLC and the FLP did not contain all of Mrs. Kimbell's assets. She retained over $450,000 in assets outside of those entities in order to meet her personal expenses. She retained control of the Trust assets through her role as Co-Trustee so that the transfer by the Trust to the entities was a transfer by Mrs. Kimbell.

The FLP agreement explicitly stated that the purposes of the FLP were to:

> increase Family wealth; establish a method by which annual gifts can be made without fractionalizing Family Assets; continue the ownership and collective operation of Family Assets and restrict the right of non-Family members to acquire interests in Family Assets; provide protection to Family Assets from claims of future creditors against Family members; prevent transfer of a Family members interest in the Partnership as a result of a failed marriage; provide flexibility and continuity in business planning for the Family not available through trusts, corporations, or other business entities; facilitate the administration and reduce the cost

> associated with the disability or probate of the estate of Family members; promote the Family's knowledge and communication about Family Assets; provide resolution of any dispute which may arise among the Family in order to preserve Family harmony and avoid the expense and problems of litigation; and consolidate fractional interests in Family Assets.[18]

Even though the FLP agreement provided that the general partner, the LLC, owed no fiduciary duty to the FLP, the agreement did state that the general partner owed a duty of loyalty and care. The Trust as limited partner had no right to withdraw from the FLP until or even receive a return of contributions until the FLP was terminated, which could occur before its forty year term only by unanimous consent of all classes of partner. The agreement finally provided that 70% in interest of the limited partners had the right to remove the general partner and that a majority in interest of the limited partners has a right to elect a new general partner.

The Court of Appeals, in reaching its decision concerning the bona fide sale of Mrs. Kimbell's assets for an adequate consideration, determined that those assets must not be recaptured into her estate for estate tax purposes in accord with the provisions of Internal Revenue Code Section 2036(a).

The Court indicated that Mrs. Kimbell's contribution of more than 99% of her assets into the FLLP to be managed by her son, as they were before the transfer, was not a mere recycling of value. The interest in the FLP, therefore, which Mrs. Kimbell received was a transfer for a full and adequate consideration. The Court noted that the Tax Court has many times rejected the argument that a discounted valuation of a pro

rata partnership interest forbids a court finding that such an interest is adequate consideration for the assets transferred.

The transfer, furthermore, was made in good faith and that a bona fide business interest was accomplished through the transfer of assets to the FLP. Those business interests were cited in the FLP agreement but testimony from Mrs. Kimbell's business advisor reinforced the business reasons for the creation of the entity. Mr. Michael Elyea, the advisor, indicated that Mrs. Kimbell first discussed the creation of a limited partnership in the early 1990's, about the time that the living trust was formed. In particular, a living trust would not provide creditor protection, or insulate oil and gas property owners from personal environmental liability. Mrs. Kimbell also desired to keep the assets in one pool, thereby increasing their value and to provide divorce protection. Mrs. Kimbell also wanted the assets to be continuously managed and to have provisions in the agreement for management succession. She preferred arbitration or mediation in settling family disputes.

Retained Interest: Kimbell

The Court of Appeals observed that the second exception under 2036(a) permits the FLP or FLLC transfer to escape taxation if the transferor did not retain an interest in the asset transferred. If an interest is retained, the transfers are recaptured into the estate of the decedent who retained any possession or right to income from the transferred property or retained the right to designate who would possess or enjoy that income. The agreement to retain may be expressed or implied from the control over the entity that continues.

The Court indicated that the Kimbell FLP had already qualified for exception under the bona fide sale for an adequate consideration rule. It now decided that the FLLC qualified for

exception under the retained interest rule. Mrs. Kimbell, according to the Court, did not retain sufficient control over the FLLC merely because of her 50% interest and her son David had sole management powers. Mrs. Kimbell, therefore, did not retain the right to enjoy or to designate who would enjoy the FLLC property.

Assignee or Partnership Interest: Kimbell

The Court, however, refused to decide whether Mrs. Kimbell's interest in the partnership was an assignee's interest or a limited partnership interest for the purposes of estate tax evaluation. The District Court had not yet examined the issue and the Court of Appeals refused to do so.

Bona Fide Sale for an Adequate Consideration: Bongard

On March 15, 2005 the United States Tax Court sitting in Texas decided *Estate of Wayne C. Bongard v. Commissioner of Internal Revenue.*[19] A majority of the court in this case also concluded that Code Section 2036(a) did not prevent the decedent and his family from forming the Bongard Family Limited Partnership for valid business non-tax purposes. This partnership obtained assets by way of bona fide sale of corporate stock to the partnership. The transfer of Class B membership units in a holdings company to the partnership, however, did not satisfy the bona fide exception. The decedent's estate, furthermore, retained an interest in the Class B membership units.

Section 2036(a) of the Internal Revenue Code indicates as a general rule that the value of a decedent's gross estate shall include all the property held by the decedent, including any property held by trust or otherwise, in which the decedent has

retained the possession or enjoyment of, or the right to income from the property or the right to designate persons who shall possess or enjoy the property. The Tax Court observed that Section 2036(a) may be applied to an evaluation of the estate if three conditions are met: (1) the decedent transferred the property while alive; (2) the transfer was not a bona fide sale for an adequate and full consideration; and (3) the decedent retained an interest in the transferred property which was not alienated before death.

In the case of family limited partnerships the bona fide sale requirement occurs when significant non-tax reasons create the partnership and the transferors who created the partnership receive interests proportionate to the values of the properties transferred. Mr. Bongard consulted with a number of business experts before creating a series of corporations, trusts and holding companies in order to increase the competitiveness of a family owner corporation. Additional capital other than bank loans or business income reinvestment sources was required. A public or private offering would accomplish this goal of increased business liquidity. One particular business expert drafted a memo and created a check list which detailed the specific steps: a second corporation was formed, incentive stock options were established; the decedent and the decedent's trust transferred the stock and stock options to a holding company in exchange for interest in the holding company proportionate to the stock shares which they had owned. The values of the shares held by the decedent and the trust helped to attract potential investors.

The Court concluded that Mr. Bongard's transfer of corporate stock to the holding company satisfied the bona fide sale exception of Section 2036(a). No inquiry needed to be made, therefore, concerning any retention of taxable interest in

class A Holding Company membership shares held by various trusts established by the decedent.

The decedent's transfer of Holding Company class B membership units to the Bongard Family Limited Partnership (BFLP), however, was not a bona fide sale for adequate and full consideration. BFLP never had an investment plan and never functioned as a business; the partnership additionally did not use the partnership device for credit protection nor to perform any management function.

Retained Interest: Bongard

The decedent continued to retain a 91% BFLP interest and did not make any gifts of that interest prior to his death. He also controlled the ability to liquidate BFLP's sole asset, the class B Holding Company's membership units. Because the decedent had the ability to decide when membership units and their underlying corporate stock would be redeemed, he retained the right to control those units now held by BFLP.

Assignee or Partnership Interest: Bongard

The Court in this case never decided whether Mr. Bongard's interest in the property assigned to the limited partnership was in fact an assignee or partnership interest for the purposes of estate tax evaluation. In this case the Court applied the discounts provided by the parties to the suit in their stipulation to settle issues. The Corporate stock, on its alternate valuation date, May 16th, 1999 was determined to be $32.24 per share. The parties then stipulated that the Holding's Company membership units represented by the corporate shares would be valuated in the following manner:

1. 287,620 Holding Company Class A nontaxable Units (minus 13% lack of control discount, 17.5% lack of marketability discount) – [{$32.24 – ($32.24 x .13)}– {($32.24 – ($32.24 x .13)} x .175}] = $23.14
   $23.14 x 287,620 = $6,655,527.
2. 4,621,166 Holding Company Class B taxable Units (minus additional lack of voting rights – a possible indication of an assignee rather than partnership interest) – [$23.14 – ($23.14 x .05)] = $21.98
   $21.98 x 4,621,166 = $101,573,229.[20]

CONCLUSION

The FLP and FLLC forms of business entity create desirable options for the estate plans of individuals but require practitioner and family preparation for their proper utilization. The practitioner must assist the family in forming the entity for business and financial reasons such as the protection of assets, continued family business control, protection of the family business from subsequent divorce distributions, the assurance of management continuity, and the use of a larger or alternate business entity to increase the value of family assets. Two recent cases announce certain rules: a family may certainly form a limited partnership or limited liability company for the purposes of estate planning, but such formation may not be exclusively for tax saving purposes. In order to avoid estate tax problems, the entities must be formed so that the decedent's estate has transferred the property for a bona fide consideration; the decedent and the estate have not retained an interest in the property; and the property is clearly described as a partnership interest or an assignee's interest.

ENDNOTES

[1] INTERNAL REVENUE CODE of 1986 as amended (IRC) Sections 2036(a) and following.

[2] IRC Section 701.

[3] *Knight v. Commissioner* 115 T.P.C. 36 (2000).

[4] *Estate of Strangi v. Commissioner* 115 T.C. 478, 293 F.3d 279 (5th Cir. 2002,T.C. Memo 2003-145)

[5] *Id*.

[6] FLP and FLLC formation suggestions appear in a number of studies including Gerald F. Stack, Esq., *The Family Limited Partnership and Limited Liability Company*, NYSBA/CLE 1-238 (2004); Bradford Updike, *Making Sense of Family Limited Partnership Law After Strangi and Stone, A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception*, 50 S.D. L. REV. 1, 37-39 (2005); Owen G. Fiore, *Valuation Adjustment Strategies*, 5 JOURNAL OF PRACTICAL ESTATE PLANNING, No. 2 (April-May, 2003).

[7] NEW YORK PARTNERSHIP LAW, Sections 121-201: NEW YORK LIMITED LIABILITY COMPANY LAW, Sections 201,203.

[8] *Burstein v. Central Hudson Associates*, 665 N.Y.S. 2d 262 (1st Dept. 1997); *United National Insurance Co. v. Waterfront N.Y. Realty Corp*., 907 F. Supp. 663 (S.D.N.Y. 1995); *In re Frye v. Manacare* Ltd, 431 So.2d 181 (Florida District Court of Appeals 1983).

[9] Stack, op. cit. at page 95.

[10] *Id.*

---

[11] *Kerr v. Commissioner*, 113 T.C. 449 (1999); *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001); *McCord v. Commissioner*, 120 T.C. 358 (2003).

[12] *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990).

[13] *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998); *Estate of Simplot v. Commissioner*, 112 T.C. 130 (1999).

[14] 120 T.C. 358 (2003).

[15] T. C. Memo 2000-51.

[16] T. C. Memo 2003-280.

[17] *Kimbell v. United States*, 244 F.Supp.2d 7000 (N.D. Texas 2002).

[18] *Id.* at 7003.

[19] *Estate of Wayne C. Bongard, Deceased, James A. Bernards, Personal Representative, Petitioner v. Commissioner of Internal Revenue, Respondent*, 124 T.C. No. 8 (2005).

[20] *Id*. at 62.

THE PAY GAP TAX CREDIT AS A REMEDY FOR GENDER PAY DISPARITY

By
M. Colleen Goble*
And
Dr. Sharlene A. McEvoy**
And
Dr. Catherine C. Giapponi***

I. INTRODUCTION

Before the 1960s, women either stayed home to raise children or worked in professions that were considered 'women's fields' such as nursing or teaching. Career opportunities were limited. Former Supreme Court Justice Sandra Day O'Connor graduated third of 102 students from Stanford Law School but when she applied for a position at a law firm, she was asked to fill a secretarial position instead.[1] Although women have entered the work force in large numbers in the past forty years and are better educated and have more experience than ever before, their salaries lag behind those of men's when comparing similar education, experience and occupation.[2]

Corporations have had over forty years to put in place mechanisms to ensure that women and men are treated equally in pay and promotions. In 2006, women earn on average 77

* Senior, University College at Fairfield University.
** Professor of Business Law, Charles F. Dolan School of Business, Fairfield University.
***Assistant Professor of Management, Charles F. Dolan School of Business, Fairfield University.

cents for every dollar that a man earns.[3] A gender pay gap exists in all professions regardless of whether these positions are traditionally filled by women or men.[4] One of the excuses that companies use to explain pay inequities is that women opt out of the workforce for pregnancy and child rearing.[5] Yet this does not explain disparities in compensation when looking strictly at education, profession and years of experience. The Equal Pay Act of 1963 was designed to remedy this problem, but has proven ineffective at closing the gap. This paper explores the use of the tax code to provide pay equalization and to encourage employers to address pay disparity issues.

II. BACKGROUND

In 2003 the number of working women reached nearly 65 million.[6] By 2012, it is projected that women will account for 48% of the labor force.[7] It is documented that jobs such as nursing, teaching and secretarial which have been traditionally held by women are viewed as being worth less than male-dominated occupations. Yet even in these occupations, women earn less than men. Female registered nurses earn 12% less than their male colleagues.[8] Female college and university professors earn 21% less than their male counterparts.[9] A female professor from Boise State University puts the pay gap issue in easily understandable terms. She has been a professor for 25 years and her pay gap has ranged from 20-40% when compared to men in her department. This means that she has been working "six out of her 25 years without pay".[10] In occupations such as word processing and typing which have typically been filled by women, women earn 8% less than males.[11]

In occupations that have traditionally been filled by men, the pay gap is even more pronounced. Women physicians earn 41% less than men.[12] Female computer scientists and systems

analysts, a field that women have not been particularly encouraged to enter, face a pay differential of 19%.[12] Evelyn Murphy, the author of Getting Even refers to this as 'working while female'.[13]

At the current pace, in Connecticut, it is projected that women will enjoy pay equity with men by 2050.[14] In thirteen states women will not reach parity with men until after that year.[15]

Although women have earned more bachelors and advanced degrees than men since 1982 and 1981 respectively, their salaries still lag behind men with similar degrees and experience.[16] Women have not made any headway into full pay equity. There is a large disparity which cannot be explained even when factoring in occupation, industry, race, marital status and job tenure.[17] The only plausible explanation is discrimination.

Women account for 92% of nurses and 82% of elementary/middle school teachers.[18] In fields such as civil engineering and pilots/flight engineers, women account for only 9% and 3% respectively. Even taking into consideration that the number of females entering those fields is low, salaries between men and women are still not on par which is further evidence of discrimination against women.

Numerous companies have been subjected to complaints for failing to hire or promote women. Among the more notable recent settlements was the Voice of America, U.S. Information Agency in 2000, for $543 million.[19] In 2004, Abercrombie & Fitch entered a consent decree for $50 million[19] and Morgan Stanley, an investment firm, settled for $54 million.[20]

III. PAST LEGISLATION

In 1963 Congress passed the Equal Pay Act, the first modern employment discrimination statute requiring equal pay for equal work. Since 1978, this law has been administered by the Equal Employment Opportunity Commission (EEOC). Every year since 1998, approximately 24,000 sex discrimination complaints have been filed with the Equal Employment Opportunity Commission. In 2004, 10,000 sex discrimination complaints were resolved with $100.8 million recovered in those complaints.[21] Although some claims have been resolved through EEOC, the Commission lacks the resources necessary to respond to all cases in a timely manner.[22]

IV. PROPOSED LEGISLATION

There are two legislative proposals in Congress that aim to address the pay gap issue. The Fair Pay Act (S.840/H.R.1697) would require that "jobs that are held predominantly by women could not be paid less than jobs held predominantly by men if those jobs are equivalent in value".[23] This Act does include exceptions for paying different rates if those rates are based on seniority, merit or quantity/quality of work. The other proposal is the Paycheck Fairness Act (S.841/H.R.1687) which would require a review of the EEOC data collection, make it easier for women to bring class action suits, and enlarge recoverable damages under the Equal Pay Act. Additionally, the Paycheck Fairness Act recommends measures aimed at helping employers to eliminate the gender pay gap. The Paycheck Fairness Act would bolster the Equal Pay Act in several ways (see footnote 24).[24]

V. OTHER REMEDIES

In Getting Even, Evelyn Murphy urges that the law provide an incentive for CEOs to address the gender pay gap issue by tying the bonuses of CEOs to closing the pay gap within their companies.[25] Shareholders could be instrumental in putting additional pressure on companies to take such steps.

The Massachusetts Institute of Technology (MIT), Mitsubishi, and the State of Minnesota have made strides in addressing gender pay disparities. At MIT, a female biology professor was denied an additional 200 feet of lab space, even though she knew space was available. [26] In comparing her lab space to that of her male counterparts, she found that male faculty members of the same rank had from 3,000-6,000 square feet versus her 1,500. She also found out that men of lower rank and less experience had more space than she had as a tenured, full professor. Eventually her dean helped her obtain the additional space. The professor realized that during her twenty-one years at the school, women were treated differently than men in many instances. She found that there were only 15 tenured women versus 194 tenured men, the same number as when she began teaching at MIT in 1973. A committee further examined the salary, lab and office space and presented the results to MIT's President who acknowledged the inequities and vowed to address them. Each year a committee at MIT reviews pay, hiring and promotions issues to ensure that they are equitable. The school benefited from positive publicity which showed MIT as a good model for addressing gender pay inequities. [27]

In 1996, Mitsubishi found itself in the middle of a sexual harassment class-action suit involving approximately 300 women. A firestorm of publicity followed and in a consent decree Mitsubishi agreed to pay $34 million to the employees.

Part of this settlement required that Mitsubishi be monitored for three years by representatives from the EEOC, Mitsubishi, and an external individual. Mitsubishi's management supported efforts to change the culture of the company. Without the support of management, the reforms would not have been successful.[26]

In 1982, the State of Minnesota decided to adopt a comparable worth initiative after some female employees provided evidence that jobs held by women on average paid 20% less than those of men.[28] Minnesota was the first state to pass a pay equity law for public workers, phasing pay equity in over a four year period.[29] Now the pay structure is reviewed every two years and salaries are adjusted accordingly. Women in Minnesota earn 97 cents for each dollar a man earns. While it is not on par with men, it is closer than the general female population's pay of 77 cents to each dollar a man earns.[26]

VI. A POSSIBLE TAX REMEDY

Current law has not reduced the gender pay disparity. As of 2005, women are still not on par with men with similar education and experience. Economist Heather Boushey, from the Center for Economic and Policy Research, suggested that a tax credit remedy would be a solution to the problem because it would provide some remedy for gender pay inequities.[30] Based on this idea a personal income tax credit model is proposed. A tax table could be created which would breakdown employment information by gender, age, education, occupation, region, size of company and salary. Job responsibilities would be classified based on the Hay Guide Chart-Profile Method of Job Evaluation system.[31]

The Hay System was developed by E. N. Hay & Associates, a wage and salary consulting firm, in the 1950s and

is still used today. [32] It is based on the job and does not take gender into account. The system provides "a fair and equitable method of rating the importance of all jobs in a company".[33] For example, a human resources manager position would be analyzed based on the job description for that position. The Hay System assigns a specific range of ratings such as 1-4 or 1-10 to each job requirement depending on the ranking of those requirements relative to the specific job. Job requirements include expertise, accountability, experience, functions, financial impact, discretion, number of staff supervised and influence of the position within the company. Salary ranges are then assigned without gender involvement. The focus is on the job, not the individual who fills it.

One potential scheme for a tax-based remedy, therefore, would be based upon a comparison of an employee's total compensation to that of her peers. Factors which could be used to determine job salary parity include:

- Age: 18-20, 21-25, 26-29, 30-39, 40-49, 50-59 and 60-70
- Education: high school graduate, associate's, bachelor's, master's, Ph.D., J.D., and M.D.
- Work location based on the 5 regions: North, South, East, West and Mid-West
- Company size: under 50, under 100, 101-199, 200-299, 300-399, 400-499, 500-599, 600-1,000, 1,001-4,999, 5,000-9,999 and over 10,000 and,
- Hay Score

Computations of the pay disparity tax credit would be based upon a woman's adjusted gross income (AGI) in comparison with the average AGI of a man with identical or similar job responsibilities.

Women would be able to look at the tax credit table utilizing their personal information. The table would indicate what the average man is paid that corresponds to their particular bracket. The difference between what women made and what men were paid based on comparable worth, would be the credit women would receive every April when filing their federal income tax return.

The advantage of the women's tax credit would be that women would be paid fairly for equal work as it relates to that of a man in a similar situation. Women who have been receiving public assistance could potentially now earn a decent standard of living. It has been noted that "nearly 40% of poor working women could leave welfare programs" if they received pay equity wage increases.[34] EEOC claims for pay inequities would be reduced. A women's pension and social security pension would also be higher.

Implementing the tax credit plan would initially be a large undertaking in setting up the various components involved. Once established, it would become a matter of maintaining and updating information on a yearly basis until it eventually was phased out. The complexity and cost of developing the tables, fielding questions and dealing with taxpayer confusion, and reconciling inappropriate tax credit filings would be difficult hurdles to overcome. Another disadvantage is that the burden of this remedy is carried by all of the taxpaying public. There is little incentive for offending corporations, those with significant gender pay disparities, to address the gap in their own organizations.

This IRS solution, however, is better than what is currently in place because the Equal Pay Act has not been effective in eliminating gender-based pay inequities. After forty-three years, women earn 23 cents less than a man earns for

comparable skills and knowledge. The Equal Pay Act is not effective in part because it relies on women to bring legal action against employers.[35] Pursuing legal action negatively impacts women financially as well as brings their credibility into question[36] which can hinder their future employment prospects.

A second tax credit approach to the pay gap problem draws upon the Swedish model. The Swedish Equal Opportunities Act of 1991 requires all employers, regardless of size to assess the levels of pay disparity within their own organization and to provide a remediation plan to address problems.[37] There are two main components of the policy: it prohibits gender-based discrimination and responsibility is placed squarely on employers to take steps to promote workplace equality. Employers are required to undergo this analysis and report results annually.

Using the Scandinavian model in combination with a corporate tax credit incentive would encourage companies that make progress at reducing pay disparities. This tax credit would convince corporations to address gender pay inequities which would increase shareholder confidence and generate positive publicity for the company. Such publicity would have the added benefit of being used as a recruitment tool for the corporation.

Corporations are interested in reducing the amount of corporate tax paid and typically look for opportunities to obtain tax credits. Tammy Propst, author of Incentives: There for the Asking, refers to the priority that corporations put on incentives: "companies that are most successful at doing this have made incentives and credits a priority in the corporate culture."[38] This approach still may not curb or stop gender pay inequities but is an option that should be considered.

There are some disadvantages with this strategy. Similar to the personal income tax remedy, the cost of the corporate tax credits would be borne by all taxpayers and corporations that fail to close the gap in their organizations would not be held financially accountable or required to pay their fair share. The tax credits would encourage corporations to close the gap, rather than hold the organizations directly accountable for failure to address the issue of women's pay inequities. Another disadvantage is that if the tax credit is given at the state level, corporations may shop around to see which state will provide the best tax credit incentives, which could potentially promote a bidding war among states. This tax credit scheme could also become a pawn in the political arena.

In the recent past, the State of Connecticut has used tax credits as an enticement for two companies, the Royal Bank of Scotland and UBS, an investment firm.[39] In the 1990s, Connecticut offered UBS, $145 million in corporate tax credits to relocate to Connecticut. In 2005, Connecticut decided that jobs at the Royal Bank of Scotland were worth $87,000 each in tax credits. However, both corporations are required to meet specific performance goals which are tied to increasing employment rates within Connecticut.

The advantage for Connecticut is that if goals are not met, the funds are returned. Demetrios Giannaros, member of the Connecticut Finance, Revenue and Bonding Committee believes that "taxpayer-financed breaks allow one company to have an unfair advantage over its competitors".[40] Large corporations benefit from tax credits because of the sizeable numbers of employees they employ as well as square footage of office space involved. Interestingly, a New York Times article indicated that 183 companies within Connecticut had received state financing and 68 had not met expected targets.[41]

These issues would require some consideration in developing a gender gap tax credit program.

VII. CONCLUSION

Fair pay is good strategy for employers to follow for several reasons. Many women are the breadwinners in their families and if they are paid fairly, they will not negatively affect programs such as unemployment and welfare. A report from the Institute for Women's Policy Research revealed that unequal pay takes a significant toll on working women and their families over their lifetime. The total earnings of women average only 38% of what men earn.[42] When these women are paid unfairly, it directly affects their current earnings as well as social security and pension benefits at retirement.

The Equal Pay Act has been ineffective in closing the pay gap disparity between men and women. The use of a tax credit plan either directed to women as part of their annual tax filing or to corporations as incentive to address gender pay inequities could close the gap. Pay would be fair and equal based on job responsibilities, not the gender factor.

Once women in the United States are educated about continuing pay gap issues and are informed of the tax credit plan, they will rally behind efforts to have it signed into Federal law. Corporations also would address gender-based pay inequities particularly if a corporate tax credit plan was implemented. If corporations are not aware of pay gap inequities or insist that inequities do not exist, this tax credit plan would at the very least, encourage employers to review their pay structure.

ENDNOTES

[1] EVELYN MURPHY & E.J. GRAFF, GETTING EVEN. 55 (2005).
[2] See *id*. at 17.
[3] See *id*. at 3.
[4] http://www.pay-equity.org/PDFs/PaycheckFairnessAct_April2005.pdf
[5] Murphy, *supra* note 1, at 82.
[6] http://www.dpeaflcio.org/policy/factsheets/fs_2003_prowomen.htm.
[7]http://www.dpeaflcio.org/policy/factsheets/fs_2004_Professional_Women.htm. [hereinafter *Professional Women*].
[8]*Id*.
[9]*Id*.
[10] Murphy, *supra* note 1, at 72.
[11] *Professional Women*, *supra* note 7.
[12] Available at: http://www.pay-equity.org/PDFs/ProfWomen.pdf. [hereinafter *Pay-Equity*].
[13] Murphy, *supra* note 1, at 174.
[14] http://www.aflcio.org/issues/jobseconomy/women/equalpay/CT.pdf.
[15] http://www.pay-equity.org/PDFs/payequitysummarytable.pdf.
[16] *Pay-Equity*, *supra* note 12.
[17] Available at: http://www.gao.gov/atext/d0435.txt.
[18] *Pay-Equity*, *supra* note 12.
[19] Murphy, *supra* note 1, at 58-59.
[20] Janet Stites, *Equal Pay for the Sexes*, HR MAGAZINE, May 2005, at 64-70.
[21] *Id*. at 64-70.
[22] http://www.gao.gov/new.items/gg00104t.pdf.
[23] http://www.pay-equity.org/info-leg.html.
[24] http://www.nwlc.org. This site identifies several important elements of the Paycheck Fairness Act which would allow plaintiffs to recover compensatory/punitive damages and make it easier to bring class actions claims. The law would automatically include individuals as part of a class action claim until they chose to opt out of it. It would also require the EEOC to issue pay data regulations within 18 months and oblige employers to submit pay data information which would also be useful in ensuring that employers comply with pay equity laws. It would close the broad loophole for employers in using the 'factor other than sex' defense and clarify the wording used in the Equal Pay Act as it refers to wage comparisons. The latter states that employees must be working at the 'same establishment', but the Paycheck Fairness Act would permit employees to be at another location. It would direct the Labor Department to develop wage comparison

guidelines and establish a system to be administered by the Labor Department to reward employers who have made advances to eliminate pay inequities. It would provide increased training for EEOC employees in handling wage discrimination claims. The Labor Department would be charged with ensuring that employers who do business with the government comply with equal opportunity regulations and would fund a training program to help women negotiate compensation packages.

[25] Murphy, *supra* note 1, at 287.

[26] Murphy, *supra* note 1, at 237-265.

[27] *Id.*

[28] http://www.pay-equity.org/PDFs/ProgressiveModels.pdf.

[29] http://www.cebcglobal.org.

[30] Heather Boushey. *Narrowing the Pay Gap*, THE BOSTON GLOBE, April 20, 2004, at A15.

[31] http://www.shrm.org/hrresources/WHITEPAPERS_Published/CMS_0000053ASP

[32] http://www.haygroup.com/Exertise or see http://www.worldatwork.com/annreport/generic/html/report-02-accomptl.html for information on founder Edward Ned Hay.

[33] http://www.poa.net.au/news/twi/hay_job_evaluation_scheme.htm.

[34] National Committee on Pay Equity (2000 Bureau of Labor Statistics).

[35] Andrew Taylor. *Calls for New Laws to Tackle Gender Pay Gap*, FINANCIAL TIMES, July 5, 2005, at 4.

[36] http://www.pay-equity.org fact sheet.

[37] http://www.sweden.se/templates/cs/Print_BasicFactsheet_4123.aspx

[38] Tammy Propst, *Incentives: There for the Asking*, EASTON, 39, February 2004, at 25.

[39] Avi Salzman, *Another Deal, Another Tax Break*, THE NEW YORK TIMES, September 25, 2005, at 14CN.1.

[40] *Id*. at 14.

[41] *Id*. at 14.

[42] http://www.pay-equity.org/index.

THE TRANSFER OF NONQUALIFIED DEFFERRED COMPENSATION AND NONSTATUORY STOCK OPTIONS: The Interaction of the Assignment of Income Doctrine and Internal Revenue Code §1041?

By:

Vincent R. Barrella*

I. INTRODUCTION:

The assignment of income doctrine is one of the oldest and most consistently applied of all of the common law doctrines. Its origins clearly demonstrate that the presence or absence of tax avoidance as a reason for the anticipatory division of income is not a controlling factor in the doctrine's application.[1] So long as the assignor is willing to surrender part of the "tree" (property) he can assign the "fruit" (income) produced from that portion of the tree. What generally can not be done is to assign all or a part of the fruit without transferring that portion of the tree which produces the fruit.[2] Thus, income from property can readily be assigned, provided, that the transferor is willing to transfer to the assignee an interest in the property producing the income.[3]

The rules relating to the assignment of income derived from the rendering of services are much more restrictive. In that case, the "tree" producing the "fruit" is the person providing the services. As it is impossible for a taxpayer to transfer all or part of himself to another person, earned income can not be assigned from one taxpayer to another unless the

[1*] J.D., LL.M.(Tax), C.P.A.; Associate Professor of Taxation, Pace University, New York

doctrine is overridden or otherwise rendered inapplicable. Furthermore, the fact that a taxpayer need not render any additional services in subsequent years (i.e., the income is fully earned), does not alter that result.[4] There are, however, judicial and statutory exceptions to the application of the doctrine. For example, in the domestic relations arena sections 71 (defining alimony) and 215 (allowing a deduction for alimony paid) effectively override the doctrine.

Property settlements proved to be somewhat trickier in light of the different state law provisions regarding interests in property (*i.e.*, common law v. community property rules). One of the more nettlesome decisions was the Supreme Court's opinion in *United States v. Davis*.[5] In 1984, Congress revamped the rules governing the treatment of alimony. In addition, it enacted section 1041 to alleviate some of the problems relating to property settlements. Section 1041 reverses the result in *Davis* by shifting the incidence of taxation from the transferor of property to the transferee.[6] Critical to the operation of section 1041 is a transfer of property.[7] In the case of qualified deferred compensation, Congress provided for income shifting through the mechanism of a "qualified domestic relations order," which allows for a former spouse (the transferee) to be characterized as an "alternative payee."[8] There is no parallel provision addressing the consequences of a transfer of nonqualified deferred compensation incident to a divorce.

II. REV. RUL. 2002-22

In an effort to fill that void, the Internal Revenue Service ("Service") issued Rev. Rul. 2002-22[9] wherein it set forth the position that section 1041 treatment should be extended to nonqualified deferred compensation and

nonstatutory stock options.[10] In the context of transfer incident to a divorce, the Service has effectively put nonstatutory stock options and nonqualified deferred compensation on par with statutory options and qualified deferred compensation. While it is anticipated that the Service's decision will more often than not produce favorable results, a question lingers as to whether the Service's position is justified from a purely technical point of view. For example, in the case of qualified deferred compensation, the seamless dovetailing with section 1041 is accomplished through other statutory provisions.[11] The desire to achieve symmetry is admirable; but will the Service's efforts withstand scrutiny?

The linchpin of the Service's effort to extend section 1041 treatment to nonstatutory stock options and nonqualified deferred compensation through Rev. Rul. 2002-22 is the characterization of the transferor's interest in both as property. Once the Service concluded that these interests constituted property, it followed that section 1041 could apply to a transfer of either incident to a divorce.[12] Regardless of whether the Service should have moved away from its original position regarding the primacy of the assignment of income doctrine, the ruling provides some significant opportunities for the transferor spouse and places an additional burden on the transferee spouse. For example, a taxpayer who is entitled to a significant future payment for previously provided services can avoid the limitations applicable to the deductibility of alimony by structuring the payout as a transfer of his right to the nonqualified deferred compensation.[13]

The impact of Rev. Rul. 2002-22 can be illustrated by the following. Assume that at the time of their divorce, H has a vested interest in an unfunded and unsecured nonqualified deferred compensation account. Assume further that under the terms of their 2002 divorce decree W is entitled to receive fifty

(50) percent of the balance in said account and that in the event that W should die prior to the date of payment of the deferred compensation, said amount is to be paid to her estate. In 2006, W receives $200,000 which represents her share of the balance in H's deferred compensation account at the time of their divorce.

Prior to the issuance of Rev. Rul. 2002-22, H would have recognized $400,000 of income from deferred compensation in 2006, but would have retained only $200,000 since W would have received one-half of the $400,000. H would not be entitled to an alimony deduction pursuant to section 215, because the payment to W would not meet the section 71 definition of alimony.[14] Absent characterization as alimony, the payment would be in the nature of a property settlement. Neither H nor W would recognize any gain on the transfer of the $200,000.[15] If we assume that H is taxed at the rate of thirty (30) percent on his receipt of the $400,000, the applicable tax liability would be $120,000 leaving him with only $80,000 (or approximately 29% of the after tax payment) while W ends up with $200,000 (or approximately 71% of the after tax payment).[16]

If under the terms of the divorce decree, the payment would not have survived W's death, and none of the other limitations on the characterization of the payment as alimony were applicable,[17] H may still suffer adverse consequences. For example, if H resides in a state that imposes a tax on gross income he would not derive any benefit from the alimony deduction. Consequently, he would be subject to tax on the full $400,000. If W resided in the same state, she would be taxed on the $200,000 of alimony she received. Thus, $400,000 would be taxed as the state level as though it were $600,000. Rev. Rul. 2002-22 remedies this situation since under the Service's analysis only the net amount of $200,000

would be included in H's gross income, with the remaining $200,000 includible directly in W's gross income.

In its ruling, the Service concludes that section 1041 can override the assignment of income doctrine. There is nothing remarkable or controversial about this position. The problem is that in order for section 1041 to be applicable there must be a transfer of property or rights to property.[18] The difficulty with the Service's analysis is that what is being transferred is the right to receive earned income (*i.e.*, income relating to services provided by the taxpayer). It remains to be seen whether the courts will agree with the Service that this constitutes a property right within the purview of section 1041. Compounding this problem is the fact that Congress, by providing for the inclusion of alimony by the recipient and its deduction by the payor, has provided a mechanism to shift earned income between taxpayers.

III. THE DIFFERING TREATMENT OF NON-VESTED v. VESTED RIGHTS

The Service specifically provided circumstances under which the ruling would not be applicable. One of these situations is where, at the time of the transfer, the transferor's rights are unvested or subject to substantial contingencies. [19] The Service's refusal to extend the treatment it is willing to accord vested nonqualified deferred compensation or nonqualified stock options to similar but non-vested situations raises additional questions.

The impact of the Service's refusal can be illustrated utilizing the facts set forth above, with one additional fact; that H's right to the deferred compensation did not vest unless he remained an employee of the plan sponsor for a period of four

years following the year in which the deferred compensation was otherwise earned. Under this circumstance, the Service would refuse to apply Rev. Rul. 2002-22 and would instead apply assignment of income principles thus taxing H on the receipt of the entire payment. H would suffer the adverse consequences set forth above, which the Service willing eliminated in the case of vested nonqualified deferred compensation. The Service never explained why this restrictive approach does not frustrate the purpose of section 1041. The Service also did not offer any reason for its decision to restrict the scope of its ruling in this manner, for example, what potential abuse did it envision occurring? Instead it relied on the Ninth Circuit's opinion in *Kochansky v. Commissioner*.[20]

Kochansky is, however, inapposite. At issue in that case was an attempt by an attorney to transfer to his former spouse one-half of a net contingency fee from a specific case that was yet to be resolved. Subsequent to their divorce he settled the case, and the fee was paid to him and his former wife consistent with the terms of the divorce decree. The application of section 1041 was not at issue in *Kochansky*. The Service's argument, and the Court's analysis, proceeded entirely along assignment of income lines.[21]

The Service's restrictive position is seemingly predicated upon its view that a contingent right does not give rise to property. Query whether this is inconsistent with the Congressional mandate to construe that term property broadly when applying section 1041 so as to facilitate transfers incident to a divorce? Insight into the Service's thought process can be obtained by examining the exclusion of "other future income rights" from section 1041 treatment. Indeed that is precisely the type of income interest addressed by the Ninth Circuit in *Kochansky*. A better approach would have been for

the Service to limit the scope of the ruling to deferred compensation and stock options; while at the same time making it clear that "other future income rights," whether vested or non-vested, are outside of the scope of section 1041 where those rights relate to earned income.[22]

Within the context of a divorce there is little practical difference between the a division of a taxpayer's vested right to receive deferred compensation and a right that will vest provided the taxpayer continues to be employed by the same employer for a period of time. Applying the assignment of income doctrine in either situation would frustrate the purpose of section 1041. This is especially true given the level of specificity that the courts have demanded before shifting the burden from the transferor of property to the transferee.[23] Rev. Rul. 2002-22 notwithstanding, it appears unlikely that a court will impose the additional burden on the transferee absent a clear language in the divorce decree that the imposition of this burden was intended by the parties.

In the case of nonstatutory options, this intent can be easily established through the actual transfer of said options. Assuming that the options can be transferred, the absence of an actual transfer should generally preclude the application of Rev. Rul. 2002-22. With respect to deferred compensation arrangements, to the extent that a taxpayer can assign or transfer his or her rights to said compensation, he or she should be required to do so before being able to apply the rationale of the ruling. Thus, the employer should be making payments directly to the transferee former spouse. The more difficult situation arises where the plan provides that the taxpayer's interest in the deferred compensation can not be transferred or assigned. In that case, payments are made to the employee who then makes a payment to his former spouse. In order for transferor to reap the benefit of shifting the tax burden to the

transferee, the divorce decree should contain language clearly delineating that the parties intended this result.

IV. CONCLUSION

The Service's willingness to permit divorcing spouses to shift earned income outside the parameters of a traditional alimony deduction provides taxpayers and their advisors with a significantly enhanced degree of flexibility. In order to take advantage of this flexibility it is imperative that the rights and obligations of the parties be clearly set forth. A court confronted with determining whether Rev. Rul. 2002-22 should be applied to shift the incidence of taxation from the transferor spouse to the transferee spouse should not be left to guess as to the party's intent. This is particularly important since it is unclear whether the result reached under Rev. Rul. 2002-22 is the correct one.

ENDNOTES

[1] *Lucas v. Earl*, 281 U.S. 111 (1930). The assignment of income at issue in *Earl* arose as a consequence of an agreement entered into years before the enactment of the income tax in 1913. Thus, there was no question that tax avoidance motive was not a motivating factor in the income splitting arrangement.

[2] An exception to this general rule is found in *Blair v. Commissioner*, 300 U.S. 5 (1937). *Blair* involved a situation wherein the transferor did have any interest in the underlying property producing the income (*i.e*, his interest was solely that of an income beneficiary). The taxpayer assigned a portion of his right to receive income to a third party. Holding that he transferred a

---

portion of everything he had, the Court allowed the transfer and refused to apply the assignment of income doctrine.

[3] *See, Helvering v. Horst*, 311 U.S. 112 (1940). The transferor need not transfer his entire interest in property to another in order to effectuate an assignment of income; however, that which he transfers must include an ownership interest in the property itself as opposed to simply the income to be produced from the property.

[4] *See, e.g., Helvering v. Eubank*, 311 U.S. 122 (1940), *reh. denied*, 312 U.S. 713 (1941), wherein the taxpayer sought to assign the income from insurance renewal commissions. These commissions required no further activity by the taxpayer. Despite this, the renewal commissions did not lose their status as earned income, so as to allow them to be characterized as property, or fit within the more liberal approach of *Blair*. *See*, note 2, *supra*.

[5] 370 U.S. 65 (1962), *reh. denied*, 371 U.S. 854 (1962). The *Davis* opinion complicated matters concerning property settlements by imposing an additional cost upon the transferor spouse in the form of a tax liability based upon the appreciation in the assets transferred in exchange for the transferee spouse's marital rights. This additional cost, however, was generally a burden only in common law states, since the joint ownership interest in community property states eliminated much of the problem.

[6] Section 1041 accomplishes this by treating the transfer as a gift and by providing that the transferee takes a carryover (the transferor's basis) in the property. See, §1041(b)

[7] Also essential to any analysis is a determination of the nature of the interest transferred in connection with the divorce. That is, was an interest in property subject to gain or loss transferred, or was the property being transferred simply the proceeds from the subsequent sale of the property? *See*, text accompanying note 23, *infra*. The answer to this question is vitally important in determining the

appropriate tax consequences of a property transfer governed by section 1041.

[8] *See*, Section 414(p)

[9] 2002-1C.B. 849. The Service subsequently has issued Rev. Rul. 2004-60, 2004-24 I.R.B. 1051, which addresses the question of the appropriate treatment for employment tax purposes of a transfer within the purview of Rev. Rul. 2002-22.

[10] This represented a reversal of the Service's previous position, that the assignment of income doctrine controlled the outcome in this area. Examples of the Service's more restrictive approach can be found in FSA 200005006, 2/4/2000 (involving nonstatutory stock options) and PLR 9340032, 7/06/1993 (involving nonqualified deferred compensation).

[11] *See*, note 8, supra.

[12] Congress intended that in applying section 1041, the term property be broadly construed so as to ease the burden associated with transfers in connection with a divorce. Balding v. Commissioner, 98 T.C. 368, 371 (1992); s*ee*, *also*, H.R. Rep. No. 432, 98 Cong., 2d Sess. 1491, 1492 (1984)

[13] Under Rev. Rul. 2002-22, the deferred compensation which is assigned to his former spouse never comes into his income; therefore, sections 71 and 215 relating to the characterization and deductibility of alimony are inapplicable.

[14] The fact that the W's right to receive the applicable percentage of H's deferred compensation survives her death would preclude the treatment of the payment of said sum as alimony. *See*, §71(b).

[15] This would be true even if H received property from his employer instead of cash. The property would be included in his gross income at its fair market value and he would take as his basis in said

property that same amount. Section 1041 would protect both H and W upon the transfer of the property, and W would take H's basis in the property. Thus, if W were to immediately sell the property for its fair market value, W would not recognize any gain or loss.

[16] The adverse tax effect could be exacerbated if any of the limitations based upon gross income or adjusted gross income where triggered. See, e.g. §165(h)(2) relating to the limitation on the deductibility of a casualty loss. In addition, H would be liable for any applicable FICA tax applicable to the $400,000 payment.

[17] *See, e.g.*, §71(b) and §71(f)

[18] *See*, §1041(b)

[19] The ruling specifically provides that it "does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer."

[20] 92 F.3d 957 (9th Cir. 1996)

[21] Based upon the manner in which the case was argued, had the matter giving rise to the fee been resolved and the taxpayer been entitled to receive a specific sum certain at the time of the divorce, it is unlikely that the Service or the Ninth Circuit would have reached a different result. However, had the taxpayer argued section 1041 and if the Service is correct, that vested future right to receive income from services gives rise to property, within the meaning of section 1041, then a division of a fee similar to the one at issue in *Kochansky* should be respected.

[22] The Service cited a number of pre-section 1041 cases in support of principle that transfers between divorcing spouses were not voluntary assignments so as to trigger the application of the assignment of income doctrine. These cases -- *Meisner v. United States*, 133 F.3d 654 (8 Cir. 1998) (transfer of a royalty interest);

Kenfield v. United States, 783 F.2d 966 (10 Cir. 1986) (transfer of a partnership interest); *Schulze v. Commissioner*, T.C.M. 1983-263 (transfer of an interest in a lawsuit); and *Cofield v. Koehler*, 207 F. Supp. 73 (D. Kan. 1962) (transfer of savings bonds) – did not involve the transfer of a right to receive earned income. It should be noted, however, that the lawsuit in Schulze was brought in part to recover partnership income, but that was but one aspect of the overall claim assigned to the taxpayer's former spouse. Moreover, the assignment of the interest in the lawsuit was part of an overall plan to divide the separately held property of the taxpayer and his former spouse.

[23] *See, e.g., Balding v. Commissioner,* 98 T.C. 368 (1992) (wife was not required to include in her income payments received from former husband in lieu of her share of his military retirement pay); Witcher v. Commissioner, T.C. Memo 2002-292 (wife had to include portion of husband's military retirement pay paid directly to her pursuant to a state court award); *Yankwich v. Commissioner,* T.C. Memo 2002-37 (court refused to tax transferee spouse on gain from an installment sale; separation agreement did not transfer beneficial interest in the obligation to the transferee); *Weir v. Commissioner*, T.C. Memo 2001-184 (transferor spouse taxed on receipt of payments made to her by her former husband; payments treated as former husband's military pension in light of clear language in the agreement); *Suhr v. Commissioner,* T.C. Memo 2001-28 (court ordered award of one-half of the proceeds from the sale of a house did not constitute an award to him of an ownership interest in the property); *Urbauer v. Commissioner*, T.C. Memo 1997-227 (court refused to tax transferee spouse on gain from sale of house; transferee did not acquire a beneficial interest in the house by virtue of her interest in the sales proceeds); *Friscone v. Commissioner*, T.C. Memo 1996-193 (while legal title to shares of stock was not transferred , the divorce decree left no doubt that there was a transfer of the beneficial ownership of the stock).

USING GOOD STORIES TO TEACH THE LEGAL ENVIRONMENT

by

Arthur M. Magaldi*
Saul S. Le Vine**

It has become a kind of pedagogical principle that the lecture method has limited value as a teaching tool. In general, instructors are encouraged to use lectures in a limited way or to avoid them completely. Despite the ongoing criticism of lectures, lectures remain central to the teaching approach of most Business Law instructors and the authors are no exception in this regard. Certainly most instructors enjoy a lively exchange with students when that is available or can be promoted. Both the case method and the Socratic method are excellent; group projects and student classroom presentations are valuable, but if one observes what is actually being done in class one sees that many classroom presentations are lectures. "In the United States lecturing is the most common method when teaching adults. And so it is all over the world."[1] Since the lecture method continues to be the preferred pedagogical approach of many, perhaps most, instructors, the authors often have pondered why the improvement of lectures has not seemed to draw the attention of scholars as much as the

---

* Professor of Law and Chair, Department of Legal Studies & Taxation, Pace University, Lubin School of Business, New York

** Professor of Law, Department of Legal Studies & Taxation, Pace University, Lubin School of Business, New York

criticism of the lecture approach has. It certainly seems that more attention has been paid to telling instructors not to lecture than to how to make lectures more interesting. The authors always enjoy presentations on pedagogy because despite the ever-present emphasis on research and publication in academia the teaching of students and the facilitation of their learning is still the most satisfying part of the job. With this background in mind, this article presents some teaching ideas. The following material is presented as collegial sharing of ideas. There is, of course, no suggestion that this is *the* way to teach the material in question, but the approaches described below have been found helpful by students and by the authors.

The theme of this paper is that good stories help to make good lectures because people remember good stories and learn from them. History is a series of stories. Feminists may argue that history as generally presented is predominantly "his story" which should be more gender balanced, but few would argue that much of history is based on stories. The most read book, the Bible, is replete with stories. Who is not familiar with the story of Noah and the Ark? People who know the story also know the basic message that the story conveys. "Stories have played an important role in our cultural history, identified as a component of every cultural group around the world. Today, they remain an integral part of everyday life. Stories touch a very primeval part of both the teller and the listener, connecting each to the other. Communicating via stories provides a rich context that captures and conveys information beyond the simple words used."[2]

Integration of good stories into lectures makes lectures more interesting. Students also enjoy stories in which the humanity of the parties is clear, i.e., they make mistakes, have problems, and all is not necessarily perfect. Hypotheticals in comparison are generally sanitized and one dimensional. Students are used

to telling stories and listening to stories. Simply put, they relate to them. Years after taking a course, students remark, "I still remember that story you told about…" If the story can be slightly humorous, that is definitely another positive, but this is not essential. The story is the thing which is remembered and the legal point which the story develops. Many of the stories will be short in duration and could conceivably be more appropriately called anecdotes, but the essential point is that stories, appropriate to the point(s) being developed, are an aid to student learning.

Stories can derive from virtually any source, e.g., newspapers, magazines, the presentations of other scholars, current events, etc. "Everyone encounters stories every day. The morning newspapers are full of stories of the events of the previous day. The evening news conveys some of the stories from earlier that day. Television shows, from situation comedies to dramas, tell stories. A trip to the theatre is a chance to see a story told on a big screen or on a stage."[3] It is not difficult to collect short stories from these and other sources to illustrate points to students, e.g., who could avoid being aware of stories which lead to the passage of the Sarbanes-Oxley Act? The rise of Richard Grasso from the mailroom to the chairman of the New York Stock Exchange and the ultimate pay and severance package totaling millions pose interesting questions for students. If the reader found one of the stories contained in this paper to be worthwhile and wished to personalize it for classroom presentation, the reader could simply state, "A colleague at the North East Academy of Legal Studies in Business convention told this story" or "This story was contained in an article in the North East Journal of Legal Studies." Again, the point is that there is an abundance of sources for teaching stories.

A properly used and told story makes a legal point come alive for students and gives them something concrete with which to relate. In this regard, real life stories are superior to hypotheticals in that the student has the opportunity to see what has actually happened. Students especially enjoy fact-based stories from the instructor's life. The exact reason(s) for this are not completely clear, but stories from the instructor's life or experience are well received. Perhaps a story from the instructor's own experience bridges the gap between instructor and student. The instructor is now not just a person in charge of the class, but someone sharing part of his/her life experience with students. "It (the good lecture)…gives us a sense of the personal involvement of the lecturer in his or her topic."[4] The instructor becomes more real in that the story illustrates that the instructor has been a participant in life. The instructor is discussing what has happened, or what is happening within the instructor's own experience. It is no longer just "Consider this or that." It is, this is what happened and what do you think of it? An additional benefit in story telling is that students often chime in and contribute related material from their own lives or from what they have heard elsewhere.

The authors wish to make two points before specific stories are discussed. First, although stories enhance lectures and the lecture method has beneficial features, the authors are not in favor of the non-stop, opening minute-to-closing minute type lecture which drones on endlessly and runs the risk of becoming a sort of soliloquy. Rather, the lecturer should always pause at certain times to be certain that students are absorbing material by asking students questions, inquiring for comments, and generally attempting to encourage students to take a more active role in the learning process. Second, the following material, indeed the entire paper, is a collaboration, but the stories are presented as told by one instructor since that

is the manner in which the stories would be taught in a classroom setting.

THE KINDERGARTEN COLLAGE AND SPECIFIC PERFORMANCE

The following story has been found useful in illustrating the concept of the proper application of the remedy of specific performance. When my daughter Jessica was in kindergarten, she was doing some art work in school and created a kind of collage of the Verrazano Narrows Bridge which is located in our neighborhood. She drew part of the collage and cut out parts of pictures which she pasted on. At some point, she brought it home to show her mother and me. We, of course, complimented the work, to encourage her. Apparently the teacher liked the work and submitted it to a district-wide competition and it won. It was displayed in a neighborhood bank for a short time with a ribbon indicating its winning status, and like the silly proud father one might see depicted on television, I would occasionally admire "the masterpiece" as I passed by the bank. Jessica was completely unimpressed by her success, but when the collage was ultimately returned to her to bring home, she said, "Here, Dad, this is for you. You can keep it. You like it so much." I put it away and thought nothing further of it. I then found the collage perhaps twenty years later when cleaning out some items in the basement and the family enjoyed a little laugh about it because we are not an artistic family and neither Jessica nor anyone else in the family has ever created any other art works of consequence. This is all factual and I tell the students this, but I then ask them to suppose that a collector of children's art had seen the collage in the bank and approached me to buy it shortly after my daughter gave it to me. The collector offers $100 and I accept the offer and I sign a quick contract accepting a $50 down payment. I agree to turn over the collage in two weeks because I want to

give it suitable "refrigerator time." But, I then begin to have regrets thinking it is crass and mercenary to sell the collage after my daughter has just given it to me. I offer to return the down payment and ask the collector to cancel the deal. The collector is adamant, so I now offer to pay him money to cancel our contract, but the dealer refuses and then sues me.

The point of the story is that the item is unique, it is impossible to value, there is not a ready replacement available on the market, and it is a perfect place for the remedy of specific performance. Accordingly, the court would likely order the collage turned over to the collector. Students invariably connect with the story, perhaps because they have drawn things which were then hung on their parents' refrigerators, praised, etc. Importantly, the illustration of specific performance becomes clear in their minds.

SOMETIMES THE DAMAGES TAIL WAGS THE DOG

Students often have difficulty understanding the important practical role damages play in the decision of whether or not to begin a lawsuit. Perhaps influenced by announcements in the media of large awards for seemingly modest injuries and wrongs, students often naively conclude that all wrongs should be compensated by large awards. They have difficulty accepting the role of nominal damages or the fact that attorneys often have to tell clients that they have not been injured sufficiently despite the would-be defendant's wrongdoing . For example, students struggle to accept the fact that a bank that pays a check in spite of the fact that the bank has received a valid stop payment order is not liable to the drawer unless the drawer proves that the drawer was not liable to the holder of the check, i.e., the bank is not liable simply for making a mistake which does not result in a loss to its depositor. It is instructive to remind students that mistakes are made all the

time, but only those which result in damages are compensable in lawsuits. Every attorney has, of course, had the experience of telling a client that he/she is correct on the law or on the liability portion, but that there are simply not enough damages to make a lawsuit worthwhile. Students are surprised to learn that absent special circumstances, such as a clause in a contract or statutory authorization, attorneys' fees are not recoverable in a successful lawsuit. Similarly, the non-recovery of awards for emotional distress in contract cases also makes the proper calculation of the amount of damages that may be recovered a crucial decision in bringing the case.

A client approached the instructor and related that his stepdaughter, a nursing student in a college in upstate New York, had been severely injured in a toboggan accident when she struck a small stump or growth of some kind which was just on the outer portion of the run or slightly off it. The toboggan overturned and her mangled leg required three operations which caused her a great deal of pain and suffering. She lost a year of school to her recuperation. The client asked that a lawsuit be begun on her behalf alleging it was negligent to have the stump or growth on the toboggan run or closely adjacent to it. The client was advised to seek the advice of local counsel in the area where the accident occurred for logistical and practical reasons, but several attorneys in the area had already refused the case. They were, in his words, "turned off" by the fact that she had successfully negotiated the toboggan run once. The accident victim accompanied her stepfather to my office limping badly a year after the injury, still in great pain and needing at least one more operation on her leg.

The instructor referred her case to a top negligence firm in New York City where a friend was a partner. Some weeks later after her situation had been evaluated by the firm, my

friend called to say that the firm could not represent her. He indicated that a great deal of time had passed since the accident and that they would have to send an investigator to the area at a substantial expense and that conditions on the toboggan run may have changed. My friend ended by saying, "You don't know those farmers upstate. They are not like city juries. They're so tight-fisted that even when you win, you get a crummy award. They don't like New York City lawyers coming up and suing local residents either. The partners feel it's just not worth the expense and effort."

I understood the decision, but was disappointed because I hoped the young woman would be able to have her day in court. Reflecting on the matter for a couple of days, I called my friend back and asked him to take a second look at the matter focusing on the damages. My argument was that with the terrible damages she had suffered, the case was worth "a shot." A winning award would have to be very substantial and therefore the firm's contingent fee would be large. The firm sent an investigator to the site where he found the stump in question. The firm took the case spending several thousands of dollars in investigating the matter. Ultimately, the matter was settled for the then-substantial sum of $149,000.

It was clearly a situation in which the amount of damages sustained greatly influenced the decision to sue and serves as an illustration that students remember quite well. In discussing this case, it is generally wise to caution students that great damages do not necessarily equate with great recoveries. It is necessary to bring the two ingredients together – liability and damages. Finally, a good concluding remark is to remind students that they do not want to recover large judgments because that means that they have suffered substantial losses. Using business law and business sense to foresee and avoid problems is the greatest benefit one can obtain from a business

law course. Another point worth mentioning is that the case also reflects the value of the sometimes maligned contingent fee arrangement between attorney and client.

A TOTAL LOSS THAT TRULY BECAME A TOTAL LOSS

The following story helps students with the basic idea of a total loss as a fire insurance concept, but it also incorporates a number of other worthwhile business law concepts regarding the need for estate planning and the fact that clients and business may come from unexpected sources.

Carmine sold a home and financed the purchase in part by taking back a mortgage on the property. Since each monthly payment was part interest and part principal, the seller wished to know the breakdown of the payments. This took place before computers were popular and these items were readily available on the Internet. I obtained a schedule from a financial company once I knew the principal amount, the interest rate, and the length of time of the mortgage. Carmine asked how much my fee was, but I advised that I had really done no work and to accept it as a gift. I mentioned that the schedule had only cost $3. He professed amazement about not being charged, but I was even more amazed when my telephone began ringing with numerous referrals from Carmine. It seems that he was a member of a large family and also had many friends who were active in buying houses, businesses, etc. They would often begin, “Carmine said to give you a call.” I was, of course, delighted by this unexpected largesse.

One day about 3:00 a.m., I was awakened by telephone calls from insurance adjusters advising me that Carmine’s home had burned down. One even rang my doorbell around 6:30 a.m. soliciting me, despite the fact that it is illegal to

solicit the creation of a fire insurance adjuster contract after 6 p.m. on the night of a fire. The next day I went to Carmine's house and found him standing in a kind of Gone With the Wind tableau amidst the rubble completely covered with soot and dirt. The pungent smell of burnt, wet wood filled the air. There was, however, a shell of his house behind him. I expressed my regrets and Carmine indicated gratitude to God that his family had been unharmed. He indicated that it was then only a matter of money and asked for my help. I said that I of course would do whatever I could and left him looking for items of personal interest in the debris.

Teenagers had set the back porch of his house on fire hoping to burglarize the homes of neighbors who would necessarily come out to see the fire. They had been arrested and had confessed. The fire from the porch then burned the house from the ground floor going up through the center of the structure. There was a structure with extensive water damages and broken windows standing in the end which had been gutted by the fire as the fire went up through the center of the building.

The insurance company initially contended that the fire loss was not total. In television ads, one may be "in good hands" and "receiving a check that same day", but such was not the case for Carmine. The teaching point concerns the rather straightforward definition of a total loss and how that may be determined and calculated. Certainly no business law instructor has difficulty explaining that principle, but presented in the context of Carmine's story, the students internalize and personalize the concept. The company eventually relented and accepted that the home was a total loss and a settlement was arranged without retaining a fire insurance adjuster.

Carmine was a junior high school shop teacher who was quite handy with home improvements, and along with family and friends restored his home. It apparently turned out quite well, but two years later en route to a museum he died of a heart attack. Whether the attack was the result of stress caused by the fire, overexertion in renovating, or a congenital ailment, or a combination will remain a mystery.

Carmine's widow began to call me telling me that Carmine had planned for the college education of his three teenage children. He had an "in trust for" or Totten trust bank account for each of the children. This financial arrangement was created to motivate each child by making it clear that funds were available for future studies. Unfortunately, Carmine never foresaw his early demise and this proved to be a very poor plan. The children who were now the owners of the accounts and without the guidance of their father, showed little interest in attending college and began to buy sports cars, take vacations, and spend extravagantly as soon as they gained access to the accounts. The widow requested some type of legal intervention to prevent this waste, but no legal remedy was available.

The story of Carmine incorporates a number of business law teaching points – the basic or literal concept of a total loss in a fire insurance setting, the fact that appropriate professional setting of fees may be vital to one seeking to build a client or customer base, and the need for all people to have an appropriate estate plan. The instructor might spend some time asking students what conclusions they draw from the story. The human elements remain with students who often later during the term ask how Carmine's children turned out.

The deposited acceptance or "mail box" rule is a basic and simple contract principle concerning acceptance of an offer and

the fact that an acceptance will generally be considered effective when properly sent to the offferor unless the offeror has indicated that the offer must be received to be effective. The following story concerning that rule has amused students.

As a young attorney, the instructor was involved with complicated litigation which was somewhat time sensitive. The instructor had worked as co-counsel with an older attorney from another firm who was the lead attorney on the matter. After years of preparation and on the eve of trial, a settlement was reached which was favorable to our client. The lead attorney forwarded the necessary paperwork to me for review and my signature and prepared everything for my signing, including the stamped envelope which in the lower left hand corner indicated, “Attention, Alexandria (last name of his secretary)”. I reviewed the matter promptly, signed off on the matter, placed the material in the stamped and addressed envelope, and mailed it. Unfortunately, the mail did not arrive. My co-counsel contacted me to ask why so much time had passed without me finalizing the matter and why the mailed communication had not arrived. I was informed that there was a real danger that the settlement would fall because of the delay. I interrupted a busy schedule and traveled a great distance the next day to his office where the papers were re-executed and the settlement was salvaged. To my surprise, there seemed to be some doubt on the part of my co-counsel as to whether I had actually mailed the papers. I found this intimation unsettling and insulting, but I decided that perhaps the pressure of this case or other matters had affected his judgment.

More than three months later, the original communication mailed by me was returned to me. The envelope was filthy and appeared as if it had been stepped on many times, there was a great deal of foreign writing on it and numerous postmarks,

and someone had written in red ink, “Not Egypt, USA.” Apparently, in one of the classic mishandlings of mail, it had inexplicably been sent to Alexandria, Egypt. After making copies of the envelope, I again forwarded it to my co-counsel with a brief triumphant note attached explaining why the material had not been received.

The teaching point is that if the mailed response had been an acceptance of an offer sent in a timely manner the result would have been the formation of a contract despite the fact that the mail was not received. It serves as a good illustration of the dangers of the deposited acceptance rule for offerors. As a practical point, it is well to ask students why they would ever make an offer and not specify that acceptance would have to be received by a certain date to be effective. In addition, the development of e-mail and the fax machine make the mail box rule less compelling today, but the story remains worthwhile in that it presents somewhat amusing possibilities for those who do not take safeguards. The students enjoy looking at the copy of the tattered envelope.

WILLS, ESTATES, AND PASSAGE OUTSIDE THE WILL

Few topics rival estates as topics of interest tostudents. Students love to consider estate possibilities like the right of election of a surviving spouse, the *per stirpes* distribution of the estate to children who represent a deceased parent, the intestacy rules, and the ability of parents’ to disinherit children. The passage of items outside or irrespective of a will is also of interest to students.

The latter point is illustrated by the tale of Albert and Karen who were brother and sister. The two approached the instructor and asked for assistance in the probate of the will of their recently deceased father, a widower. The will was

executed two years before the testator's death, appointed them co-executors, and left the entire estate to them in equal shares. The witnesses were readily available to perform their duties and the deceased was said to have owned his home, several bankbooks with considerable sums, and had life insurance on his life. Albert and Karen seemed to legitimately grieve the passing of their father, and were anxious to move forward with the probate of the will.

The matter unfolded, however, in a very strange manner. Investigation of the title of the house revealed that it was owned in a joint tenancy with the right of survivorship with a brother of the testator. The joint tenancy and survivorship aspect were specified in a deed recorded by the father after the death of his wife. Regarding the bank books in question, one was "in trust for" the deceased's brother and the second was "in trust for" Karen. The life insurance named a charity as the beneficiary.

Despite these unexpected findings, the beneficiaries named in the will, Karen and Albert, protested that the will left everything equally to them. They were, of course, dismayed to learn that the passage of title to the house, the proceeds of the insurance policy, and the bank accounts had not been part of the probate estate, were not affected by the will, and had, in fact, passed outside of it. The paradox as to why the deceased testator had written his will in the manner above described was unsolvable. Had the deceased acted out of ignorance thinking that the will would supersede the joint tenancy, the life insurance beneficiary designation, and "in trust for" provisions? Was the testator simply not thinking, and did the attorney who drafted the will caution the testator to adjust the beneficiaries of the insurance and bank account to reflect the testator's wishes? A good discussion point for students is to lead them to the realization that one's Last Will and Testament

is only a part of their estate plan and that those leaving property must take pains to insure that their entire disposition of property after their demise reflects their carefully considered intentions. It is instructive to ask students how they think the matter should have been set up by the testator, why they think the testator acted as he did and whether it might be concluded that the attorney who drafted the will was remiss in his/her duties. The story also may be used as a catalyst to lead to a discussion of Living Wills and durable powers of attorney.

CONCLUSION

One means of enriching lectures is to relate meaningful stories to the students, stories which are based on real life situations. Students seem to particularly enjoy stories in which the instructor has been a participant or stories from the instructor's personal experience. "Just as a picture is said to be worth a thousand words, a story conveys so much more meaning than the simple words used to tell it. Members of the business community have an untapped capacity to receive such messages in story form. Both anecdotal evidence and existing research supports considering stories as a legitimate vehicle for communicating important messages."[5]

Meaningful stories can be obtained by an instructor from virtually any source. It may be effective to determine the point the instructor wishes to develop and to find a story that fits that situation. More likely the instructor will recall or think of a story from his/her experience to develop a point. Where the story is not one from the instructor's experience, stories abound in the media to fit almost any situation.

ENDNOTES

1. DONALD S. BLIGH, What's The Use of Lectures? 3 (2000).
2. Richard G.Weaver (2005)*Using Story to Convey Important Messages to a Business Audience,* Proceedings of American Society of Business and Behavioral Sciences, Vol.12, Number 1, 1830.
3. Id. at 1831.
4. Margaret Morganroth Gullette, Editor, The Art and Craft of Teaching, citing Dubrow and Wilkinson *The Theory and Practices of Lectures* p.25 (1982).
5. Note 2 at 1836.