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Federal Taxation

by Augustus N. Makris

I. INTRODUCTION

This Article surveys certain federal tax cases decided by courts in the Eleventh Circuit in 2010. There were no significant decisions. The case of Ocmulgee Fields, Inc. v. Commissioner addressed the applicability of section 1031(f)(4) of the Internal Revenue Code (I.R.C.) to like-kind exchanges. The case of United States v. Fort involved a partner who, in exchange for his interest in an acquired partnership, received shares of the acquiring corporation subject to certain restrictions. The issue was whether the restrictions permitted the partner to exclude the

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2. The year 2010 saw a number of “tax-protestor” cases in courts in the Eleventh Circuit. See, e.g., Martins v. United States, No. 10-12086, 2010 WL 4721610 (11th Cir. Nov. 23, 2010). Perhaps the most colorful of these cases involved movie actor Wesley Snipes, who appealed his criminal convictions for willfully failing to file federal income tax returns. See United States v. Snipes, 611 F.3d 855, 859 (11th Cir. 2010). Snipes made several arguments justifying his failure to file his personal tax returns, including that he was a non-resident alien to the United States, that earned income must come from sources wholly outside the United States, that a taxpayer is defined by law as one who operates a distilled spirit Plant, that the Internal Revenue Code’s taxing authority is limited to the District of Columbia and insular possessions of the United States, exclusive of the 50 States of the Union, [and] that as a fiduciary of God, who is a nontaxpayer, he was a foreign diplomat who was not obliged to pay taxes. Id. at 860 (internal quotation marks omitted).
3. 613 F.3d 1360 (11th Cir. 2010).
5. Ocmulgee Fields, 613 F.3d at 1361.
7. Id. at 2560.
shares from gross income when received. The case of *Southern Family Insurance Co. v. United States* addressed whether “takeout bonuses” paid by a state to an insurance company were included in gross income or excluded from gross income as nonshareholder contributions to capital.

II. **OCMULGEE FIELDS, INC. v. COMMISSIONER**

“When a taxpayer exchanges one property for another, the exchange is typically treated for tax purposes as a sale of the relinquished property followed by a purchase of the received property.” Under I.R.C. § 1001(c), the taxpayer must immediately recognize the gains or losses realized. Under I.R.C. § 1031(a), however, gain or loss is not recognized on exchanges of certain business or investment property “solely for [other] property of like kind.” The long-standing concept underlying I.R.C. § 1031 is that when a taxpayer exchanges one property (the “relinquished property”) for a replacement property of like-kind (the “replacement property”), the taxpayer is continuing an ongoing investment, rather than disposing of one property to obtain another. Accordingly, gain or loss is not recognized, and under I.R.C. § 1031(d) the taxpayer’s basis in the relinquished property carries over to the replacement property.

The transfer of the relinquished property in exchange for the replacement property need not be simultaneous. I.R.C. § 1031(a)(3) can apply to a “deferred exchange,” defined by the regulations “as an exchange in which, pursuant to an agreement, the taxpayer transfers [the relinquished] property . . . and subsequently receives [the replacement] property.” Generally, the replacement property must be identified within 45 days and received within 180 days of the transfer of the relinquished property.

8. See id. at 2560-61.
10. Id. at 7200.
11. *Ocmulgee Fields, Inc. v. Comm'r*, 613 F.3d 1360, 1364 (11th Cir. 2010).
13. Id.
15. Id.
17. *Ocmulgee Fields*, 613 F.3d at 1364.
18. I.R.C. § 1031(d).
20. Treas. Reg. § 1.1031(k)-1(b) (as amended in 2008).
I.R.C. § 1031(a)(3), however, does not alter the rule that I.R.C. § 1031 applies only to exchanges of property and not cash sales, which can make deferred exchanges difficult to execute. For example, if a taxpayer sells the relinquished property for cash and then uses the cash to purchase replacement property, gain or loss is recognized on the sale even if the transaction falls within the 45-day and 180-day windows.

The regulations provide various rules designed to mitigate this and other problems presented by deferred exchanges. Under one such rule, if a taxpayer transfers the relinquished property to a “qualified intermediary,” and the qualified intermediary sells the relinquished property for cash proceeds, then, generally, the proceeds held by the qualified intermediary are not considered to be received by the taxpayer. This rule permits a qualified intermediary to effect a deferred exchange by collecting cash proceeds from the sale of the taxpayer’s relinquished property without the recognition of gain, using the cash proceeds to purchase the replacement property and transferring the replacement property to the taxpayer.

Prior to the enactment of I.R.C. § 1031(f) in 1989, related taxpayers acted in concert to exploit the nonrecognition treatment and carry-over basis provisions of I.R.C. § 1031. According to the House Ways and Means Committee,

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. . . . The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, “cashed out” of the investment, and the original exchange should not be accorded nonrecognition treatment.

I.R.C. § 1031(f)(1) provides that when a taxpayer exchanges property with a “related person” (as defined in I.R.C. § 1031(f)(3)), gain or loss that would otherwise escape recognition is recognized by the taxpayer if

22. See Treas. Reg. § 1.1031(k)-1(g)(4) (as amended in 2008).
23. See id.
25. Ocmulgee Fields, 613 F.3d at 1366.
the taxpayer or the related person disposes of the property exchanged or received by the taxpayer within two years of the exchange.\textsuperscript{27} I.R.C. § 1031(f)(2) can save nonrecognition treatment if the taxpayer establishes that neither the exchange nor the subsequent disposition of the exchanged property was principally motivated by the avoidance of federal tax.\textsuperscript{28}

An additional limitation is provided for in I.R.C. § 1031(f)(4), which disallows nonrecognition treatment for "any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of" I.R.C. § 1031(f).\textsuperscript{29} "Congress enacted § 1031(f)(4) to prevent related parties from structuring transactions in a manner that avoided the technical provisions of § 1031(f)(1) but achieved the same result § 1031(f)(1) was designed to prevent."\textsuperscript{30}

I.R.C. 1031(f)(4) was at issue in the case of Ocmulgee Fields.\textsuperscript{31} The case dealt with an exchange that involved four parties: "(1) Ocmulgee Fields (the taxpayer); (2) Treaty Fields (a related person); (3) the McEachern Family Trust (an unrelated purchaser of property); and (4) Security Bank of Bibb County (Security Bank) (a qualified intermediary)."\textsuperscript{32} Ocmulgee Fields was taxable as a corporation, and Treaty Fields was taxable as a partnership.\textsuperscript{33} Each entity was a real estate development and management company owned by members of the same family.\textsuperscript{34} Thus, they were related persons under I.R.C. § 1031(f)(3).

Ocmulgee Fields had a basis in its property, Wesleyan Station, of $716,164.\textsuperscript{35} Ocmulgee Fields conveyed Wesleyan Station to Security Bank, which sold it to the McEachern Family Trust for $6,838,900, causing Ocmulgee Fields to realize a gain of $6,122,736. Security Bank then used the proceeds to purchase the Barnes & Noble Corner property from Treaty Fields for $6,740,900. Treaty Fields' basis in that property was $2,554,901, so the sale caused Treaty Fields to recognize a gain of $4,185,999. Next, Security Bank transferred the Barnes & Noble Corner property to Ocmulgee Fields. If Ocmulgee Fields had immediately recognized the $6,122,736 gain it realized, it would have been taxed at

\begin{itemize}
  \item \textsuperscript{27} I.R.C. § 1031(f)(1).
  \item \textsuperscript{28} I.R.C. § 1031(f)(2)(C).
  \item \textsuperscript{29} I.R.C. § 1031(f)(4).
  \item \textsuperscript{30} \textit{Ocmulgee Fields}, 613 F.3d at 1367.
  \item \textsuperscript{31} See id. at 1361.
  \item \textsuperscript{32} \textit{Id.} (footnote omitted) (internal quotation marks omitted).
  \item \textsuperscript{33} \textit{Id.} at 1372.
  \item \textsuperscript{34} \textit{Id.} at 1361.
  \item \textsuperscript{35} \textit{Id.} at 1363.
\end{itemize}
a 34% corporate tax rate, yielding an immediate tax liability of more than $2 million. Because Treaty Fields was a partnership, it passed the $4,185,999 gain recognized on its sale through to its partners who were taxed at a 15% rate.36

The Internal Revenue Service (IRS) issued a deficiency against Ocmulgee Fields, asserting that Ocmulgee Fields failed to meet all of the requirements of I.R.C. § 1031(f) and, consequently, incurred approximately $2 million in additional tax liability. The United States Tax Court agreed with the IRS and held that the exchange was not entitled to nonrecognition treatment under I.R.C. § 1031(f)(4). Ocmulgee Fields appealed.37 The United States Court of Appeals for the Eleventh Circuit affirmed the decision of the tax court.38

The decision in the case can be best understood if it is considered in light of an alternative set of facts. Again, Ocmulgee Fields, which owned Wesleyan Station (basis $716,164), and Treaty Fields, which owned Barnes & Noble Corner (basis $2,554,901), were owned by members of the same family.39 Suppose the family wanted to cash in its investment in Wesleyan Station. Prior to the enactment of I.R.C. § 1031(f), the family had at least two options. First, it could have simply caused Ocmulgee Fields to sell Wesleyan Station to a third party for $6,838,900, recognizing gain of $6,122,736. Alternatively, Ocmulgee Fields could have transferred Wesleyan Station to Treaty Fields for Barnes & Noble Corner in an exchange qualifying under I.R.C. § 1031(a). Under I.R.C. § 1031(d), Treaty Fields would have had a carryover basis in Wesleyan Station of $2,554,901. On the following day, Treaty Fields could have sold Wesleyan Station to a third party for $6,838,900, recognizing a gain of $4,283,999. The second option would have reduced the gain recognized on the sale of Wesleyan Station by $2,554,901 ($6,838,900 minus $4,283,999).

I.R.C. 1031(f)(1) closes the door on the second option. As stated above, I.R.C. § 1031(f)(1) denies nonrecognition treatment on an exchange if the related person disposes of the relinquished property “before the date 2 years after the date of the last transfer which was part of [the] exchange.”40

In its tax return for the relevant year, Ocmulgee Fields identified its like-kind exchange with Security Bank (an unrelated party) as one that

36. Id. at 1362-63.
37. Id. at 1363-64.
38. Id. at 1364.
39. Id. at 1363.
qualified for nonrecognition treatment under I.R.C. § 1031(a). Thus, I.R.C. § 1031(f)(1) did not technically apply to deny nonrecognition. But, according to the court, the only purpose of interposing Security Bank was to avoid the application of I.R.C. § 1031(f)(1). Thus I.R.C. § 1031(f)(4) applied.

Moreover... we can look to the unneeded complexity in the series of transactions to help us in inferring Ocmulgee Fields' intent.... Ocmulgee Fields could have achieved the same result by simply engaging in a direct exchange of property with Treaty Fields, and Treaty Fields could have then sold Wesleyan Station to the McEachern Family Trust. If Ocmulgee Fields had taken this approach, however, § 1031(f)(1) would have automatically disallowed nonrecognition treatment for the exchange because Treaty Fields disposed of Wesleyan Station within two years of the exchange.... Therefore, unless Ocmulgee Fields offered a persuasive justification for the complexity of its transactions, we can infer that Ocmulgee Fields added layers of complexity to avoid the purposes of § 1031(f).

Ocmulgee Fields offered no such persuasive justification and, therefore, the court held that the exchange was "structured to avoid the purposes of § 1031(f)." Thus, the court denied nonrecognition treatment under I.R.C. § 1031(f)(4). In short, Ocmulgee Fields stands for the proposition that parties to an I.R.C. § 1031 like-kind exchange cannot, as part of a deferred exchange, circumvent the prohibition in I.R.C. § 1031(f)(1) on selling the relinquished property within two years of the exchange by selling the relinquished property through a qualified intermediary before the exchange is complete. According to the court, such transactions are "the economic equivalent of a direct related-party exchange for which § 1031(f) would disallow nonrecognition treatment."

41. 613 F.3d at 1363.
42. Id. at 1369-70.
43. Id. at 1370, 1373.
44. Id. at 1373.
45. See id. at 1369-70.
46. Id. at 1369.
III. United States v. Fort

The case of United States v. Fort involved Cap Gemini's 2000 purchase of an information technology consulting firm owned by Ernst & Young. As part of the transaction, Ernst & Young partners exchanged their partnership interests in the firm for shares of Cap Gemini, which was a publicly-traded French corporation. In 2000 Cap Gemini transferred 25% of the agreed-upon shares to the Ernst & Young partners, and Merrill Lynch held the remaining 75% of shares in accounts for each partner. The shares held in the Merrill Lynch accounts could not be sold for up to five years. If a partner quit, was fired, or engaged in competition with Cap Gemini, the shares held in the Merrill Lynch account would be forfeited. To account for these restrictions, the restricted shares were valued at 95% of the closing price of Cap Gemini stock on the closing date.

Danny Fort, a former Ernst & Young partner, reported the shares he received (including the restricted shares) as income on his 2000 tax return. The share price plummeted in the following years. After the drop in price, Fort filed an amended tax return, requesting a refund on the grounds that the restricted shares were subject to substantial restrictions and therefore should not have been considered income in 2000. The IRS granted the refund and then brought suit to recover the refund issued.

Under I.R.C. § 61, gross income includes all income "that is actually or constructively received during the taxable year." The issue was whether Fort constructively received the restricted shares originally claimed as income in 2000. The United States District Court for the Northern District of Georgia wrote that "the key to constructive receipt is control." A taxpayer constructively receives income if the income is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time. Constructive receipt does not occur, however, "if the taxpayer's control of its receipt is subject to

48. Id. at 2560.
49. Id.
51. Fort, 105 A.F.T.R.2d (RIA) at 2560.
52. Id.
53. Id. at 2561.
54. Id. at 2560-61 (internal quotation marks omitted).
Fort argued that the sale restriction and the forfeiture provision imposed substantial restrictions on his control of the shares and, therefore, he did not constructively receive them in 2000. The court disagreed and held that Fort “exercised substantial control over all of the shares in 2000,” notwithstanding the restrictions. The court found the following facts persuasive:

[Fort] alone stood to gain or lose money based on the stock's performance. He received the benefit of the dividends paid on the shares, and he had the right to direct how the shares would be voted. He knowingly agreed to the sale restriction and the forfeiture provision. He also agreed to the amount of the discount.

The forfeiture provision did not prevent Fort from constructively receiving the shares. The court wrote, “the fact that the partners risked having to return some of their shares at a later time does not mean that they did not constructively receive the shares in the first place.” The court noted that “several courts have held that, where stock is transferred under a sales agreement and held in escrow to guarantee a party's performance under the agreement, the party receives the stock when it is placed in escrow rather than when it is released.” Therefore, the court held “that Fort constructively received the shares in 2000.”

The court noted that its finding was consistent with the contemporaneous holdings of other courts that had considered the tax consequences of the exact same type of transaction. In addition, the court noted that its holding was “consistent with the parties' original intentions.”

Moreover, the court understood that the parties structured the transaction as they did because the Ernst & Young partners expected the shares to appreciate and wanted to recognize all of the income from

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57. Id.
58. Id.
59. Id.
60. Id.
61. Id. (quoting United States v. Fletcher, 562 F.3d 839, 844 (7th Cir. 2009)) (internal quotation marks omitted).
62. Id.
63. Id.
64. Id.
the transaction in 2000. Any appreciation would therefore be taxed as capital gain. "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.""}

IV. **Southern Family Insurance Company v. United States**

The case of *Southern Family Insurance Co. v. United States*, addressed whether "takeout bonuses" paid by a state to an insurance company were included in gross income or excluded from gross income as nonshareholder contributions to capital. Following the aftermath of Hurricane Andrew in 1992, a number of property and casualty insurers ceased writing or renewing windstorm insurance policies in Florida. As a result, the state of the Florida and its residents faced an insurance crisis. In response to the crisis, the State passed legislation creating the Residential Property and Casualty Joint Underwriting Association (JUA) as a windstorm insurer of last resort.

The JUA's business grew rapidly, and after only eighteen months of operation, the JUA had become the third largest insurer in the State. In order to encourage private insurers to re-enter the market, the State passed legislation that provided "takeout bonuses" to private insurers for each risk they removed from the JUA. The takeout bonuses were not, however, paid to the insurers immediately. Instead, the takeout bonuses were paid into an escrow account. The trustee of the escrow was permitted to release the takeout bonuses only after certain conditions were satisfied.

Generally, insurers were required to provide coverage under a policy for three years before the corresponding funds were released. Upon the expiration of the three-year period, the JUA would conduct an audit to determine whether the insurer had provided the applicable insurance and otherwise complied with the conditions. Following the audit, the takeout bonuses, together with any interest, were released to the

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65. *Id.*
66. *Id.*
68. 106 A.F.T.R.2d (RIA) 7200 (M.D. Fla. 2010).
69. *Id.* at 7200.
70. *Id.*
insurer. State law required the takeout bonuses, once released to an insurer, to be credited to the insurer's capital and surplus. Any portion of the funds deemed not payable to the insurer would be returned to the JUA.\textsuperscript{71}

The Southern Family Insurance Company (Southern Family) was formed in 1996 to write residential insurance policies and ultimately took over thousands of policies from the JUA. As a result, the JUA deposited takeout bonuses into an escrow account pursuant to an escrow agreement between the JUA and Southern Family. The takeout bonuses relevant to this case were deposited in the escrow account during the calendar years 1996-1999. During those years, the JUA deposited into escrow the following takeout bonuses for policies transferred to Southern Family: $7,125,000 for 1996; $4,754,281 for 1997; $2,430,458 for 1998; and $832,100 for 1999.\textsuperscript{72} During the escrow periods, many policies were cancelled or not renewed. As a result, at the end of the escrow periods, the escrow agent released to the Southern Family: $6,876,500 for 1996; $4,859,913 for 1997; $2,392,590 for 1998; and $394,050 for 1999.\textsuperscript{73}

The JUA approved the first release of funds to Southern Family in 1999. These funds related to policies “taken out” by Southern Family during the 1996 taxable year. Southern Family accounted for these takeout bonuses as a direct contribution to capital and surplus and did not report them as taxable premium income on its 1999 federal income tax return. For the taxable years 1996-1998, Southern Family did not file a stand-alone tax return, as it had in 1999. Rather, Poe Financial Group, Inc. (Poe Financial), the common parent of a group of corporations that included Southern Family, filed a consolidated return.\textsuperscript{74}

Following an examination of the consolidated tax returns for 1996-1998 along with Southern Family's 1999 tax return, the IRS issued notices of deficiency to Poe Financial for 1996-1998 and Southern Family for 1999. The IRS determined that the taxpayers had improperly treated the takeout bonuses as capital contributions and therefore had erroneously excluded the payments from gross income. The taxpayers paid the deficiencies and filed for refunds, which the IRS denied. The taxpayers filed refund actions in a federal district court.\textsuperscript{75} That court

\textsuperscript{71} Id. at 7200-01.
\textsuperscript{72} Id. at 7201-02.
\textsuperscript{73} Id. at 7202.
\textsuperscript{74} Id.
held that the takeout bonuses were appropriately characterized as nonshareholder capital contributions. The Eleventh Circuit affirmed.\textsuperscript{75}

I.R.C. § 61(a) states the following: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived."\textsuperscript{76} I.R.C. § 118(a)\textsuperscript{77} excludes from gross income "any contribution to the capital of the taxpayer."\textsuperscript{78} Under Treasury Regulation § 1.118-1,\textsuperscript{79} contributions to capital can be money or property and can be made by either a shareholder or a nonshareholder.\textsuperscript{80} Respecting nonshareholder capital contributions, I.R.C. § 1.118-1 provides contrasting examples:

For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.\textsuperscript{81}

Citing Supreme Court of the United States and Eleventh Circuit precedent, the Middle District of Florida held that the determination of whether a nonshareholder contribution of money or property is included in gross income as a payment for services turns on the intent of the contributor.\textsuperscript{82} The court wrote that when a transferor makes "payments with the intention of receiving a direct benefit in the form of specific services, the payments [cannot] be considered a contribution to capital."\textsuperscript{83} In contrast, when a transferor contributes capital with the intention of benefiting the community generally, the contribution is treated as a nonshareholder capital contribution.\textsuperscript{84}

\textsuperscript{75} Id.
\textsuperscript{76} I.R.C. § 61(a) (2006).
\textsuperscript{77} I.R.C. § 118(a) (2006).
\textsuperscript{78} Id.
\textsuperscript{79} Treas. Reg. § 1.118-1 (2001).
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Southern Family, 106 A.F.T.R.2d (RIA) at 7203.
\textsuperscript{83} Id. (quoting United States v. Coastal Utilities, Inc., 483 F. Supp. 2d 1232, 1239 (S.D. Ga. 2007)) (internal quotation marks omitted).
\textsuperscript{84} See id. at 7203-04.
Brown Shoe Co. v. Commissioner involved transfers of cash and other property made by civic groups to induce the taxpayer to build and operate facilities in their communities or expand the facilities already there. The civic groups “expected only that the transactions would benefit the community at large by providing jobs[,] there were ‘neither customers nor payments for service.’” The Supreme Court has recited five other characteristics of nonshareholder capital contributions:

[1] The contributed capital must become a permanent part of the transferee’s working capital structure. [2] It may not be compensation . . . for a specific, quantifiable service. . . . [3] It must be bargained for. [4] [It] must result in benefit to the transferee in an amount commensurate with its value. And [5] the asset ordinarily . . . will be employed in or contribute to the production of additional income.

In Southern Family, the Middle District of Florida held “that it was the intent and motivation of the Florida Legislature and the JUA for the takeout bonuses to constitute nonshareholder contributions to capital.” That conclusion was consistent with state law, which expressly required insurers to credit the takeout bonuses to capital and surplus. In addition, and perhaps most importantly, the court found that the purpose of the program was to benefit the Florida insurance market generally by providing an incentive to bring capital into Florida for the creation of insurance companies that would provide coverage to Florida homeowners. The JUA “was not paying for any specific good or service.” Of course, Southern Family did transfer economic value to the JUA when Southern Family assumed a portion of the JUA’s liabilities. The court did not address this issue. Accordingly, the court held that “the takeout bonuses were nonshareholder contributions to capital and thus excludable from gross income.”

86. Id. at 584.
88. Id. at 7203-04 (quoting United States v. Coastal Utilities, 483 F. Supp. 1232, 1240-41 (S.D. Ga. 2007)).
89. Id. at 7204.
90. Id.
91. Id.
92. Id.
93. Id.