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Federal Taxation

by Ben E. Muraskin[*]
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The Court of Appeals for the Eleventh Circuit during 1997 rendered fewer reported decisions dealing with federal tax issues than in prior years. Nevertheless, in one of the biggest developments in cooperative taxation, the Eleventh Circuit decided *Gold Kist Inc. v. Commissioner*,[1] which involved the interpretation of the tax benefit rule as set forth in the 1983 Supreme Court decisions in *Hillsboro National Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*[2] Other decisions involved the qualification of corporations as "farm-related taxpayers," employment taxes, federal tax liens, issues on appeal, litigation costs, and a bankruptcy tax issue.

I. COOPERATIVE TAXATION AND TAX BENEFIT RULE

In *Gold Kist Inc. v. Commissioner*, the Eleventh Circuit reversed the Tax Court, concluding that Gold Kist Inc. ("Gold Kist") did not have to recognize income when it redeemed its equity from some of its patrons for less than the amount it deducted in connection with the original issuance of the equity.[3] This decision marked the end of a dispute with

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1. 110 F.3d 769 (11th Cir. 1997).
2. 460 U.S. 370 (1983) (companion cases).
3. 110 F.3d at 769.

the Internal Revenue Service ("IRS") that had lasted nearly twenty years.

Gold Kist, a nonexempt farmers' co-operative, is subject to Subchapter T ("Subchapter T") of the Internal Revenue Code of 1986, as amended.[4] For many years, Gold Kist issued the bulk of its patronage dividends as qualified patronage dividends, which are dividends paid to its patrons partly in cash and partly by the issuance of instruments Gold Kist called "notified equity."[5] These instruments entitled the holder to receive the stated amount of notified equity at a future time if and when Gold Kist redeemed or revolved the notified equity.[6] Gold Kist properly claimed a deduction when the notified equity was issued under section 1382(b)[7] both for the cash and the portion of the dividend paid as notified equity. As provided under section 1385, each of the patrons receiving the qualified patronage dividend consented to take the full stated amount of the dividend, including the stated amount of the notified equity, into income at that time.[8] Thus, as provided by Subchapter T, earnings of Gold Kist paid out as qualified patronage dividends were taxed once to the patron and not to Gold Kist.[9]

Gold Kist was not required to redeem any of its notified equity from its patrons. Nevertheless, at the discretion of its board, Gold Kist typically revolved or redeemed its notified equity for cash at its full stated amount after approximately twenty years. In addition, Gold Kist would redeem a patron's outstanding notified equity upon the patron's death, also at its full stated amount, even though that patron's notified equity might not be eligible for redemption for a number of years. The redemptions at issue, however, were in a third category. These redemptions were from patrons who had terminated their membership in Gold Kist and had requested payment for their equity. In that instance Gold Kist would redeem the notified equity for cash at its present value. Present value was determined pursuant to company policy based on the current interest rates on Gold Kist's fifteen-year capital certificates of interest and on the assumption that the former member's notified equity otherwise would be revolved at the estimated revolving date, or earlier, based on the former member's anticipated life

4. *Id.* Subchapter T includes sections 1381 through and including 1388. 26 U.S.C. §§ 1381-1388 (1994).

5. 110 F.3d at 771 n.4.

6. *Id.* at 770.

7. 26 U.S.C. § 1382(b). If certain requirements are met, a co-operative is allowed to deduct its patronage dividends. *See id.*

8. 110 F.3d at 771; 26 U.S.C. § 1385.

9. 110 F.3d at 771.

expectancy using standard mortality tables.[10] Once a member's equity was redeemed early, absent individual approval of the management executive committee of Gold Kist, the former member could not again become a member of Gold Kist.[11]

It is important to note a number of features surrounding the facts of this third category of redemptions. First, Gold Kist did not have any preconceived plans or programs to redeem specific holders or specific amounts of notified equity, and it did not have any plans or arrangements that would encourage its patrons to terminate membership and withdraw their notified equity early.[12] Second, the redemption was prompted by the patron and not Gold Kist.[13] Finally, the amount redeemed early represented only one or two percent of the total outstanding balance of notified equity in any given year.[14]

Arguing that a portion of the earnings of Gold Kist would otherwise escape being taxed, the IRS took the position that the tax benefit rule required Gold Kist to take into income an amount equal to the difference between the amount deducted by Gold Kist upon the original issuance of the notified equity and the present value amount used to redeem the notified equity early.[15] Gold Kist took the position that this difference was not income to it and put forth two main arguments. First, it argued that the notified equity was equity for tax purposes.[16] As a redemption of equity, the redemption came squarely within the provisions of section 311(a), which provides that no income results from the redemption of "stock" for cash.[17] Further, even if section 311(a) was inapplicable, the federal income tax law has always treated the redemption of equity for cash as a capital transaction not giving rise to taxable income or loss.[18]

Second, Gold Kist argued that the tax benefit rule as outlined in the Supreme Court decisions in the companion cases *Hillsboro National Bank v. Commissioner* and *United States v. Bliss Dairy, Inc.*[19] did not apply to require income recognition.[20] According to the Supreme Court, the tax benefit rule only requires the inclusion of income when "the later event is indeed fundamentally inconsistent with the premise on which

10. *Id.*
11. 104 T.C. 696, 702 n.7 (1995).
12. *Id.* at 698-704.
13. *Id.* at 702.
14. *Id.* at 704 n.1.
15. 110 F.3d at 771.
16. 104 T.C. at 709.
17. 26 U.S.C. § 311(a) (1994).
18. 104 T.C. at 716-19.
19. 460 U.S. 370 (1983).
20. 110 F.3d at 771.

the deduction was initially based."[21] Based in part on the legislative history of Subchapter T, Gold Kist reasoned that a patronage dividend deduction is premised on the patron's consent to include the dividend in income, and nothing changed that fact when Gold Kist subsequently redeemed the notified equity even at less than the full stated amount.[22] In addition, Gold Kist stated that there is simply no requirement under Subchapter T that any amount ever be paid to patrons for their notified equity.[23] Thus, to Gold Kist the redemption of the notified equity for less than its stated amount could not be fundamentally inconsistent with the original patronage dividend deduction.[24]

The Tax Court issued its opinion on June 26, 1995 and rejected Gold Kist's arguments.[25] Gold Kist appealed the decision of the Tax Court, and on April 21, 1997, in a per curiam opinion, the Eleventh Circuit found that the tax benefit rule did not require a co-operative to include these amounts in income.[26] The Eleventh Circuit agreed with Gold Kist's view that the deduction phase of the transaction was complete after the patron had given consent to include the full stated amount of the patronage dividend in income.[27] It also agreed with Gold Kist that the deduction of a qualified patronage dividend is not premised on the assumption that any particular amount, or indeed any amount at all, necessarily will be paid to patrons for their notified equity.[28]

II. QUALIFICATION AS A "FARM-RELATED TAXPAYER"

In *Golden Rod Farms, Inc. v. United States*,[29] the Eleventh Circuit considered whether a corporation can qualify as a "farm-related taxpayer" within the meaning of section 464(f)(3)(B),[30] an issue of first impression.[31] Golden Rod Farms, Inc. ("Golden Rod"), an Alabama corporation, raises broiler chickens for resale. In 1987 Golden Rod paid

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21. 460 U.S. at 383.
22. 110 F.3d at 771.
23. *See id.*
24. *Id.*
25. 104 T.C. at 719.
26. 110 F.3d at 772-74.
27. *Id.* at 773.
28. *Id.*
29. 115 F.3d 897 (11th Cir. 1997).
30. 26 U.S.C. § 464(f)(3)(B) (1994). A "farm-related taxpayer" is a taxpayer "(i) whose principal residence . . . is on a farm, (ii) who has a principal occupation of farming, or (iii) who is a member of the family." *Id.* Golden Rod conceded that as a corporation it did not have a principal residence and was not a member of a family. However, it maintained that it was a taxpayer with a principal occupation of farming and thereby met the criteria of section 464(f)(3)(B). 115 F.3d at 898.
31. 115 F.3d at 897.

over twenty million dollars for feed and feed ingredients. Golden Rod deducted the entire twenty million dollars from its 1987 income although it had used only a portion of the feed materials during that taxable year.[32] In 1988 Golden Rod again deducted the entire amount of its feed purchases despite the fact that only a portion of these materials was used during the taxable year. The IRS asserted that Golden Rod was precluded from deducting the entire amount it spent on feed in the year of purchase because Golden Rod was not a farm-related taxpayer within the meaning of section 464(f)(3)(B). As a result, the IRS assessed deficiencies against Golden Rod for the deductions it claimed on its 1987 and 1988 tax returns for feed purchased in the applicable year but not used in that year. Golden Rod paid the deficiencies, filed an unsuccessful administrative claim for refund, and then filed an action to recover the amount of additional taxes assessed plus interest.[33]

The district court held that Golden Rod qualified as a "farm-related taxpayer" under section 464(f)(3)(B),[34] and the Eleventh Circuit affirmed.[35] In reaching its conclusion, the court of appeals examined the plain language and the legislative history of the statute. To qualify as a farm-related taxpayer under the plain language of the statute, Golden Rod had to be considered a taxpayer in the principal occupation of farming.[36]

The IRS contended that Golden Rod could not meet the definition of a farm-related taxpayer because corporations, unlike individuals, did not have occupations but rather had trades or businesses.[37] The IRS argued that other terms contained in section 464(f)(3)(B) confirmed Congress's intent that a farm-related taxpayer must be an individual. Specifically, the IRS noted that the terms "residence" and "family" only apply to individuals.[38]

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32. *Id.* at 898. The IRS argued in the district court that Golden Rod, a cash basis taxpayer, could not take a deduction for the purchase of feed not used during the fiscal year of purchase. Golden Rod Farms, Inc. v. United States, 652 F. Supp. 972, 973 (N.D. Ala. 1986). The district court disagreed and held that Golden Rod was entitled to a current deduction for the purchase of feed used in the year following purchase because the purchase was a true purchase and not a refundable deposit; the purchase was made for a valid business purpose; and the deduction did not result in a material distortion of income. Thus, Golden Rod's deduction met the three-part test of Rev. Rul. 79-229, 1979-2 C.B. 210. *See* 652 F. Supp. at 999.

33. 115 F.3d at 898.

34. 652 F. Supp. at 999.

35. 115 F.3d at 900.

36. *Id.* at 898.

37. *Id.* at 898-99.

38. *Id.* at 899. The terms "residence" and "family" are used in the definition of a farm-related taxpayer. *See* 26 U.S.C. § 464(f)(3)(B) and *supra* note 30.

Golden Rod asserted that Congress's use of the term "taxpayer," which is statutorily defined to include corporations as well as individuals, clearly established Congress's intention that a corporation is eligible to qualify as a farm-related taxpayer.[39] In addition, Golden Rod argued that "business" and "occupation" are synonymous terms applying equally to corporations and individuals.[40]

After considering both arguments, the court concluded that the statutory phrase was ambiguous and did not plainly exclude corporations.[41] Although the court agreed that the word "occupation" is most commonly used to refer to the job of an individual, it noted that legislatures have used the term "occupation" to refer to the activity of a corporation.[42] Furthermore, the court stated that the use of the word "taxpayer" instead of "individual" in section 464(f)(3)(B) suggested that Congress did not intend to limit the application of the section to individuals.[43]

Because the language of the statute was ambiguous, the court examined the legislative history of section 464 to determine Congress's intent.[44] The court determined that Congress's intent when drafting the deduction limits of section 464(f) was to thwart tax-sheltering activities and to assure that taxpayers with full-time farming activities are not subject to the deduction limitations.[45] The court noted that the applicable legislative history did not differentiate between corporate and individual taxpayers engaged in full-time farming activities.[46] Because Golden Rod was clearly engaged in full-time farming activities and not in the type of tax-sheltering activities that Congress sought to eliminate, the court concluded that Golden Rod qualified as a farm-related taxpayer within the meaning of section 464(f)(3)(B).[47]

III. EMPLOYMENT TAXES

In *Morrison Restaurants, Inc. v. United States*,[48] the Eleventh Circuit held that the IRS has authority to assess an employer's share of

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39. 115 F.3d at 899.
40. *Id.* (citing I.R.S., PUBLICATION NO. 225, FARMER'S TAX GUIDE 24 (11-97) (using "principal business" rather than "principal occupation" to explain section 464(f)(3)(B))).
41. *Id.*
42. *Id.* (citing South Covington & Cincinnati St. Ry. v. City of Covington, 235 U.S. 537, 544 (1915) (referring to the "principal occupation" of a corporation)).
43. *Id.*
44. *Id.*
45. *Id.* at 899-900 (citing S. REP. NO. 99-313, at 268 (1986)).
46. *Id.* at 900.
47. *Id.*
48. 118 F.3d 1526 (11th Cir. 1997).

employment taxes on unreported tips of employees on an aggregate basis without determining the under-reporting of individual employees and crediting their wage history accounts.[49] In *Morrison* the IRS assessed the taxpayer-employer over ten thousand dollars in additional employer Federal Insurance Contribution Act ("FICA") taxes[50] for unreported tip income by applying a formula[51] estimating tips received by its restaurant employees.[52] The IRS did not credit the individual employees' wage history accounts nor did it determine the amount of unreported tip income for each employee.[53]

Taxpayer won summary judgment in the district court on the ground that an assessment of the employer's share of FICA taxes on unreported tips in the aggregate without Social Security benefits to the tipped employees is contrary to the legislative purpose of the Social Security Act, which at least in part is to provide benefits correlating with the amount of FICA taxes credited to the individual employee.[54]

On appeal, however, the Eleventh Circuit noted that the Social Security Act states that its purpose is also to encourage states to furnish financial assistance to aged, needy individuals, and it is not limited to providing benefits equivalent to FICA taxes paid by employees and employers.[55] Further, the Eleventh Circuit found that employees who fail to report tip wages waive the right to be credited for their employer's share of FICA taxes on the unreported amounts and that the employers are not harmed by their employee's waiver.[56] The court also noted that the provision imposing tax liability on the employee is separate and independent from the provision imposing tax liability on the employer.[57] Finally, the court stated that tips are deemed to be paid from the

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49. *Id.* at 1530.

50. Employees are subject to FICA taxes on all wages earned with respect to employment. 26 U.S.C. § 3101(a), (b) (1994). Similarly, employers are subject to FICA taxes on all wages paid to an employee in the course of employment. 26 U.S.C. § 3111(a), (b) (1994). Wages include tips. 26 U.S.C. § 3121(a), (q) (1994).

51. *See* McQuatters v. Commissioner, 32 T.C.M. (CCH) 1122 (1973) (setting forth a formula for estimating the amount of tips for the purpose of collecting individual income tax on unreported tips).

52. 118 F.3d at 1527-28.

53. *Id.*

54. Morrison Restaurants, Inc. v. United States, 918 F. Supp. 1506, 1514 (S.D. Ala. 1996).

55. 118 F.3d at 1530 (citing 42 U.S.C. § 301 (1994)).

56. *Id.*

57. *Id.* at 1529. FICA taxes on wages received by an employee are imposed by 26 U.S.C. § 3101(a) and (b) while FICA taxes on wages paid by an employer are imposed by 26 U.S.C. § 3111(a) and (b).

employer.[58] Thus, the court supported the IRS's interpretation of the statute.[59]

IV. FEDERAL TAX LIENS

In *Litton Industrial Automation Systems, Inc. v. Nationwide Power Corp.*,[60] the Eleventh Circuit held that a federal tax lien had priority over an unperfected security interest in intangible property.[61] On April 15, 1986, Nationwide Power Corporation ("Nationwide") granted a security interest in its cause of action against Litton Industrial Automation Systems, Inc. to Highlander International Corporation ("Highlander") as collateral for a debt Nationwide owed to Highlander. On June 9, 1986, the IRS obtained a tax lien with respect to Nationwide's property, including its cause of action, by making an assessment on Nationwide for over $700,000 in tax penalties. On July 3, 1986, the IRS properly filed a notice of tax lien against Nationwide.[62] The question on appeal required a determination of the relative priority of Highlander's and the IRS's interests in the cause of action on July 3, 1986.[63] This centered on whether Highlander's interest constituted a "security interest" within the meaning of section 6323(h)(1).[64]

A tax lien, the notice of which has been properly filed, is not valid against the holder of a security interest within the meaning of section 6323(h)(1) who did not have actual knowledge of the tax lien at the time the security interest came into existence.[65] Because Highlander received its interest in the cause of action prior to the federal tax lien's existence, Highlander could not have had actual knowledge of the tax lien at that time. Thus, the priority battle turned on whether Highlander's unperfected interest qualified as a "security interest" within the

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58. 118 F.3d at 1530. "[T]ips received by an employee in the course of his employment shall be considered remuneration for such employment" and deemed paid by the employer for purposes of 26 U.S.C. § 3111(a) and (b). 26 U.S.C. § 3121(q).

59. 118 F.3d at 1529. Courts review an administrative agency's statutory interpretation de novo but defer to its reasonable interpretation. Alabama v. United States Dep't of Interior, 84 F.3d 410, 412 n.2 (11th Cir. 1996).

60. 106 F.3d 366 (11th Cir. 1997).

61. *Id.* at 374.

62. *Id.* at 367-68. A federal tax lien generally arises upon assessment. 26 U.S.C. § 6322 (1994).

63. *See* 106 F.3d at 367-69.

64. *Id.* at 368 (citing 26 U.S.C. § 6323(h)(1) (1994)). A security interest generally includes any interest in property acquired by contract for the purpose of securing payment of an obligation, and a security interest exists at the time when the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation. 26 U.S.C. § 6323(h)(1).

65. *See* 26 U.S.C. § 6323(b)(1)(B) (1994).

meaning of section 6323(h)(1).[66] A security interest as defined therein must, among other requirements, be protected under local law against certain subsequent "judgment liens."[67]

On this issue the Eleventh Circuit looked to federal, not state, law to interpret what is meant by the undefined term "judgment lien."[68] Relying in part on the legislative history of the Federal Tax Lien Act of 1966[69] and the U.S. Department of Treasury's interpretation of the term as evidenced by its regulations,[70] the court concluded that a "judgment lien" is equivalent to a perfected interest held by a U.C.C. lien creditor.[71]

Because the holder of a judgment lien[72] has a perfected interest that would take priority over Highlander's unperfected interest, Highlander's interest was not protected under local law against a subsequent judgment lien. Thus, Highlander was not the holder of a "security interest" within the meaning of section 6323(h)(1).[73] Accordingly, the court held that on July 3, 1986, the federal tax lien had priority over Highlander's unperfected security interest.[74]

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66. 106 F.3d at 368-69.

67. *See id.* and *supra* note 64.

68. 106 F.3d at 371. Federal law governs a priority contest between a security interest and a federal tax lien. Haas v. Internal Revenue Service, 31 F.3d 1081, 1084-85 (11th Cir. 1994) (citing Aquilino v. United States, 363 U.S. 509, 513-15 (1960)). That federal law controls is important because the Florida Supreme Court had determined that a "judgment lien" (as used in 26 U.S.C. § 6323(h)(1)) means a "simple judgment lien," and a simple judgment creditor can not have a judgment lien against intangible property in Florida. Peninsula State Bank v. United States, 211 So. 2d 3, 5 (Fla. 1968).

69. Pub. L. No. 89-719, 80 Stat. 1125 (1966). In enacting the Federal Tax Lien Act, Congress intended "to conform the lien provisions of the internal revenue laws to the concepts developed in [the] Uniform Commercial Code." H.R. REP. NO. 89-1884, at 1-2 (1966), *reprinted in* COMMITTEE ON WAYS AND MEANS, 89TH CONG., LEGISLATIVE HISTORY OF THE FEDERAL TAX LIEN ACT OF 1966, at 443-44 (1966).

70. 106 F.3d at 373 (citing Treas. Reg. §§ 301.6323(h)-1(a)(2) (1976) (defining judgment lien as a lien held by a judgment lien creditor) and 301.6323(h)-1(g) (1976) (indicating that a judgment lien creditor is someone who has perfected a lien under judgment on the property involved)).

71. 106 F.3d at 372. *See* U.C.C. § 9-301(3) (1972).

72. Under either U.C.C. § 9-301(3) or as interpreted under Treas. Reg. §§ 301.6323(h)-1(a)(2) and 301.6323(h)-1(g). *See supra* note 70.

73. 106 F.3d at 373-74.

74. *Id.* at 374.

V. ISSUES ON APPEAL

In *G.I.C. Corp. v. United States*,[75] the taxpayer, G.I.C., took a capital loss deduction based on the sale of three of its subsidiaries in 1984.[76] G.I.C. filed amended tax returns in 1987 and 1988 seeking a refund of the $1,580,818 in taxes it had paid for 1984 (after taking into account the capital loss deduction) based on operating losses it suffered in 1985 and 1986. The refund request prompted the IRS to re-evaluate the validity of the 1984 capital loss deduction. The IRS ultimately disallowed the deduction and filed a notice of deficiency for $1,474,822 representing the additional 1984 taxes allegedly owed by G.I.C. as a result of the disallowance of the capital loss deduction. G.I.C. paid the deficiency and filed an income tax refund claim.[77] The district court entered judgment for the taxpayer, and the IRS appealed.[78] The Eleventh Circuit affirmed the district court judgment for G.I.C.[79]

The IRS argued before the Eleventh Circuit that as a matter of law, the sale was invalid under Florida law because the sale of corporate assets was not authorized by a majority of the corporation's shareholders.[80] The court refused to consider that argument on appeal because it had not been properly raised in district court.[81] In particular, the court noted that pretrial stipulations, which were silent as to the argument regarding the invalidity of the sale under Florida law, frame the issues for trial and the parties are bound by the stipulations.[82] The IRS asserted that the court had the discretion to consider issues not raised in the pretrial stipulation to grant a party relief from the stipulation and to prevent manifest injustice.[83] The court agreed that

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75. 121 F.3d 1447 (11th Cir. 1997).

76. *Id.* at 1448.

77. *Id.* at 1447-48.

78. G.I.C. Corp. v. United States, No. 95-0168, 1996 U.S. Dist. LEXIS 20580, at *2 (S.D. Fla. May 13, 1996), *aff'd*, 121 F.3d 1447 (11th Cir. 1997).

79. 121 F.3d at 1448.

80. *Id.* at 1449. FLA. STAT. ANN. § 607.241 (repealed 1989) required that a sale of corporate assets be authorized by a majority of the corporation's shareholders.

81. 121 F.3d at 1450-51 (citing Narey v. Dean, 32 F.3d 1521, 1526 (11th Cir. 1994); FDIC v. Verex Assurance, Inc., 3 F.3d 391, 395 (11th Cir. 1993)). In district court the IRS challenged the 1984 capital loss on two grounds: (1) that a wash sale under Internal Revenue Code section 1091 had occurred, and (2) that there was no valid sale of stock in the three subsidiaries in 1985. G.I.C. Corp. v. United States, No. 95-0168, 1996 U.S. Dist. LEXIS 20580, at *2 (S.D. Fla. May 13, 1996) (citing 26 U.S.C. § 1091 (1994)).

82. 121 F.3d at 1449-50. *See* Hodges v. United States, 597 F.2d 1014 (5th Cir. 1979) (stating that parties are bound by their stipulations and pretrial stipulations frame the issues for trial).

83. 121 F.3d at 1450.

although it was not bound by the stipulation of law, the IRS should be.[84] Thus, the court held that the district court correctly decided the issues presented to it by stipulation.[85]

VI. LITIGATION COSTS IN THE TAX COURT

In *Grant v. Commissioner*,[86] taxpayers, who had successfully challenged an income tax deficiency in the Tax Court,[87] filed a motion seeking administrative and litigation costs. The Tax Court denied taxpayers' motion,[88] and the taxpayers appealed. The Eleventh Circuit reviewed the Tax Court decision and affirmed, finding no abuse of discretion.[89] The court of appeals found that taxpayers failed to satisfy their burden of proving[90] that they qualified as a "prevailing party" under section 7430.[91]

To qualify as a prevailing party, taxpayers had to establish that (1) the position of the IRS in the proceeding was not substantially justified, (2) taxpayers had substantially prevailed, and (3) taxpayers satisfied the applicable net worth requirements.[92] The IRS conceded that taxpayers substantially prevailed and met the net worth requirements.[93] The only remaining issue was whether the IRS's position was substantially justified.

The court of appeals reasoned that the IRS's position was substantially justified if there was a reasonable basis for its position in both law and fact at two distinct stages: (1) when the IRS issued the notice of

84. *Id.*

85. *Id.* at 1451.

86. 103 F.3d 948 (11th Cir. 1996).

87. Grant v. Commissioner, 69 T.C.M. (CCH) 1716 (1995).

88. Grant v. Commissioner, 70 T.C.M. (CCH) 340 (1995), *aff'd*, 103 F.3d 948 (11th Cir. 1996).

89. 103 F.3d at 953. The standard of review for the denial of a motion for an award of administrative and litigation expenses is abuse of discretion. *Id.* at 951 (citing Rasbury v. Commissioner (*In re* Rasbury), 24 F.3d 159, 165-68 (11th Cir. 1994)).

90. For a taxpayer to establish entitlement to award of costs as a prevailing party, the taxpayer must bear the burden of proving that the government's position in a tax proceeding is not substantially justified in law and in fact. 26 U.S.C. § 7430(c)(4)(A) (1994).

91. 103 F.3d at 953. For a taxpayer who prevails in an administrative or judicial proceeding to be awarded reasonable costs incurred in that proceeding, the taxpayer must demonstrate that he (1) was the "prevailing party," (2) has exhausted all available administrative remedies, and (3) did not unreasonably protract the proceedings. *See* 26 U.S.C. § 7430. The IRS conceded that taxpayers had exhausted their administrative remedies and had not unreasonably protracted the proceedings. Consequently, the only issue was whether the taxpayers qualified as a prevailing party. 103 F.3d at 951-52.

92. 103 F.3d at 952 (citing 26 U.S.C. § 7430(c)(4)(A)).

93. *Id.*

deficiency in the administrative proceedings and (2) in the period following the filing of the IRS's answer in the Tax Court litigation.[94] The IRS's position during both stages was that taxpayers constructively received income because an amount had been paid to taxpayers' agent at taxpayers' discretion.[95] Taxpayers argued on appeal that the IRS's position was unreasonable as a matter of law because the government ignored the fundamental rule that amounts are not included in gross income unless the taxpayer received some benefit from the income items. Further, they argued that the IRS ignored certain cases holding that funds misappropriated by an agent do not constitute income if the taxpayer is unaware of the misappropriation and received no benefit from the funds.[96]

The court of appeals stated that taxpayers waived their right to assert that the IRS's position was not reasonable as a matter of law because they failed to present this argument to the Tax Court.[97] The court also determined that the IRS's position was factually reasonable due to the lack of substantiated information available to the IRS at the time the notice of deficiency was issued and during the period following the filing of the IRS's answer in the Tax Court litigation.[98]

VII. BANKRUPTCY—PRE-PETITION TAXES

In *United States v. Hillsborough Holdings Corp.*,[99] the Eleventh Circuit affirmed the district court ruling that when a corporate debtor's tax year straddles the filing of a petition for Chapter 11 reorganization, taxes attributable to the pre-petition portion of the debtor's tax year are not allowable as administrative expenses under section 503(b)(1)(B)(i) of the United States Bankruptcy Code.[100] Hillsborough Holdings Corporation ("debtors") and its subsidiaries operated on a taxable fiscal year that ran from June 1 to May 31. On December 27, 1989, debtors filed a voluntary petition for reorganization. Debtors paid the taxes attributable to income earned during the postpetition part of their tax year (that is, taxes attributable to income earned between December 27, 1989 and May 31, 1990). The pre-petition taxes (that is, taxes attributable to

94. *Id. See* Pierce v. Underwood, 487 U.S. 552 (1988) (holding that the government's position is substantially justified if there is a reasonable basis for the proposition in both law and fact).

95. 103 F.3d at 952.

96. *Id. See, e.g.*, Rossi v. Commissioner, 41 B.T.A. 734 (1940).

97. 103 F.3d at 952.

98. *Id.* at 953.

99. 116 F.3d 1391 (11th Cir. 1997).

100. *Id.* at 1392 (citing 11 U.S.C. § 503(b)(1)(B)(i) (1988)).

income earned between June 1, 1989 through December 27, 1989) were not paid.[101]

On behalf of the United States, the IRS asserted that the unpaid taxes were first priority administrative expenses entitled to administrative priority.[102] Debtors asserted that the unpaid pre-petition taxes were not administrative expenses and therefore were not entitled to administrative priority.[103] On this issue, the court examined the two primary requirements for qualification as an administrative expense: (1) that the taxes be "incurred by the estate"[104] and (2) that the taxes not be of the kind specified in section 507(a)(7) of the Bankruptcy Code.[105]

With regard to the first requirement, the IRS argued that the pre-petition taxes were incurred by the estate because the entire year's taxes were "incurred" on the last day of the taxable year, which in this case fell within the period of the estate's existence.[106] Debtors counter-argued that the unpaid taxes were attributable to income earned by the pre-petition debtor and thus could not have been "incurred by the estate."[107] The court declined to decide which position was correct. Rather, the court ruled that even if it agreed with the IRS's assertion that the entire year's taxes were incurred by the estate, it could not accept the IRS's argument that the unpaid taxes were not of a kind specified in section 507(a)(7) of the Bankruptcy Code.[108] Taxes on or measured by income or gross receipts that are not assessed before, but are assessable under applicable law or agreement after, the commencement of the case are seventh in priority.[109] The court noted that the unpaid taxes fell squarely within the plain language of section 507(a)(7)(A)(iii) of the Bankruptcy Code because the unpaid taxes were not assessed before debtors filed their petition but were assessable

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101. *Id.* at 1392-93.

102. *Id.* First priority is granted to the payment of administrative expenses as defined in 11 U.S.C. § 503(b). 11 U.S.C. § 507(a)(1) (1994). Administrative expenses include taxes that are incurred by the estate. 11 U.S.C. § 503(b)(1)(B)(i).

103. 116 F.3d at 1393.

104. 11 U.S.C. § 503(b)(1)(B)(i).

105. 116 F.3d at 1394-96; 11 U.S.C. § 507(a)(1).

106. 116 F.3d at 1394. A voluntary bankruptcy case is commenced by the filing of a petition. 11 U.S.C. § 301 (1994). The commencement of a bankruptcy case creates a bankruptcy estate. 11 U.S.C. § 541(a) (1994). Pre-petition taxes are incurred by the estate. Towers v. United States (*In re* Pacific-Atlantic Trading Co.), 64 F.3d 1292, 1299-1301 (9th Cir. 1995).

107. 116 F.3d at 1394. *See In re* O.P.M. Leasing Servs., Inc., 68 B.R. 979, 983-85 (Bankr. S.D.N.Y. 1987) (holding that pre-petition taxes are not incurred by the estate).

108. 116 F.3d at 1394.

109. *Id.* Seventh priority to certain tax claims. 11 U.S.C. § 507(a)(7) (currently codified at 11 U.S.C. § 507(a)(8)).

after the filing.[110] In addition, the court joined the Eighth and Ninth Circuits in rejecting the IRS's argument that the phrase "not assessed before, assessable after" should be properly interpreted as referring to taxes that "were assessable both before and after" the filing.[111]

VIII. CONCLUSION

Although the Eleventh Circuit rendered fewer reported cases dealing with federal tax issues than in prior years, it did decide issues involving cooperative taxation, the tax benefit rule, qualification of corporations as "farm-related taxpayers," employment taxes, federal tax liens, issues on appeal, litigation costs, and a bankruptcy tax issue.

110. 116 F.3d at 1394-95.
111. *Id.*