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pretation of enlistment contracts. Because *Reamer* viewed the enlistment contract in terms of ordinary contract law, it may reflect some flexibility in the Fourth Circuit's consideration of military enlistment contracts.

The D.C. Circuit has given a flexible consideration of enlistment contracts in *Larionoff* and holds that Congress did not have the power to alter the bonus provisions in reenlistment contracts. Because it recognizes an enlistee's right to enforce a promise he has contracted for, *Larionoff* seems to be a better adjudication of the issue of VRBs than *Carini.* Furthermore, the D.C. Circuit's decision in *Larionoff* represents the growing trend of courts to interpret enlistment contracts as true contracts.[42] While *Larionoff* is limited to cases in which Congress has not justified its actions through legitimate supervening public policy, it is valuable authority for recognizing the enlistee's rights in the enforcement of his enlistment contract. Although the Fourth Circuit has not altered its interpretation of military enlistment contracts to accord with *Larionoff,* it does treat enlistment contracts as ordinary contracts in cases like *Reamer* where there is a dispute over the interpretation of the language. The volunteer Army has placed an increased importance on military enlistment contracts.[43] This, in turn, may present more opportunities for the Fourth Circuit to examine its interpretation of enlistment contracts as true contracts.

DAVID H. ALDRICH

X. TAX

A. Use and Derivative Use Immunity to Protect the Privilege Against Self-Incrimination in a Wagering Tax Refund Suit.

In a suit for the refund of federal wagering taxes, a taxpayer may find himself on the horns of a dilemma. Because the Commissioner assesses taxes on both legal and illegal wagers,[1] the production of

F.2d at 741, while in *Reamer* the Fourth Circuit interpreted a provision within the contract adversely to the enlistee's assertions. 532 F.2d at 352.

[42] *See* note 31 *supra.*

[43] *See* text accompanying notes 1-5 *supra.*

[1] I.R.C. §§ 4401(a) and 4404 impose a two percent excise tax on wagers placed within the United States or by United States citizens. Until 1974, the excise tax was ten percent of the gross wagers. I.R.C. § 4401(a) (1954) (amended 1974). To facilitate collection of this tax, the government imposes strict requirements upon wagerers. They

evidence relating to illegal betting may be necessary to support a claim for a refund. The taxpayer must refuse to produce this evidence, however, if he is to avoid criminal liability for violation of gambling laws.[2] Since refusal to produce evidence may result in dismissal of his refund suit,[3] forcing a taxpayer to choose between possible criminal liability or dismissal of his refund suit raises fifth amendment issues.

In *Shaffer v. United States,*[4] the Fourth Circuit remedied this dilemma by directing the district court to defer the refund suit until the government granted use and derivative use immunity[5] or until all

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must register with the Treasury Department, I.R.C. § 4412, keep daily records, I.R.C. § 4403, and permit inspection of those records. I.R.C. § 4423. Payment of the tax does not exempt the wagerer from prosecution for violation of gambling laws. I.R.C. § 4422. For the history of the statutes, see Chenoweth, *A Judicial Balance Sheet for the Federal Gambling Tax,* 53 NW. U.L. REV. 457 (1958).

The Commissioner collects wagering taxes through the assessment procedure. I.R.C. § 6303. Under this procedure, a lien on the taxpayer's property arises when the assessment is made, I.R.C. § 6322, and if the person liable for the tax does not pay it within ten days, the Commissioner may collect the tax by seizing the property, I.R.C. § 6331, and selling it. I.R.C. § 6335.

[2] All states and the federal government regulate gambling through criminal statutes. For a list of the state statutes, see Marchetti v. United States, 390 U.S. 39, 44-45 n.5 (1968). For examples of federal statutes, see 18 U.S.C. §§ 1302 (mailing of lottery tickets prohibited), 1952 (interstate distribution of gambling proceeds which have not been taxed prohibited), 1953 (interstate transportation of wagering paraphernalia prohibited), 1955 (1970) (operation of a gambling business illegal under state law prohibited).

[3] FED. R. CIV. P. 37(b)(2)(c) provides that a court may dismiss an action or enter a judgment by default against the disobedient party for failure to comply with an order compelling discovery.

[4] 528 F.2d 920 (4th Cir. 1975).

[5] Although the court said "use immunity," 528 F.2d at 920, it probably meant "use and derivative use immunity." Mr. Justice Douglas also used the shortened form in Kastigar v. United States, 406 U.S. 441, 466 (1972) (Douglas, J., dissenting).

Prosecutors may grant three types of immunity—use immunity, which precludes the use of the testimony in a subsequent proceeding; derivative use immunity, which prohibits the use of evidence derived from the testimony; or transactional immunity, which provides immunity from prosecution for offenses related to the testimony. *See* Kastigar v. United States, 406 U.S. 441, 443 (1972). If a witness testifies under use and derivative use immunity, the prosecutor in any subsequent proceeding must prove that his evidence is untainted by the testimony. 406 U.S. at 461-62. Under the fifth amendment, a grant of use and derivative use immunity is sufficient to compel self-incriminating testimony. Counselman v. Hitchcock, 142 U.S. 547, 586 (1892). The federal government may grant immunity from state prosecutions under the supremacy clause. Murphy v. Waterfront Comm., 378 U.S. 52, 73 (1964). *See* Note, *Resolving Tensions Between Constitutional Rights: Use Immunity in Concurrent, or Related Proceedings,* 76 COLUM. L. REV. 674, 699-702 (1976); *see generally* Note, *The Scope of Testimonial Immunity Under the Fifth Amendment:* Kastigar v. United States, 6

applicable statutes of limitation had expired.[6] In *Shaffer,* the taxpayer, who was under indictment on federal gambling charges, sued in district court[7] to obtain a refund of his partial payment of a wagering tax assessment.[8] During discovery, the plaintiff refused to answer certain questions or to produce certain records[9] relating to the compu-

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LOY.L.A.L. REV. 350 (1973); Comment, *The Fifth Amendment and Compelled Testimony: Practical Problems in the Wake of* Kastigar, 19 VILL. L. REV. 470 (1974).

[6] 528 F.2d at 922.

[7] The Tax Court lacks jurisdiction over excise tax cases because its jurisdiction is limited to cases in which the taxpayer received a notice of deficiency. Flora v. United States, 362 U.S. 145, 175 n.38 (1960); Dudley v. Commissioner, 258 F.2d 182, 183-84 (3d Cir. 1958); *see* note 1 *supra.* I.R.C. § 6212 authorizes deficiency notices only for income tax, estate tax, gift tax, taxes on private foundations and taxes on qualified pension plans. *See* 9 J. MERTEN, LAW OF FEDERAL INCOME TAXATION § 50.08 (1971).

[8] Unlike the federal income tax, the wagering tax is divisible. A taxpayer may pay a portion of the assessment and sue in district court for a refund. Flora v. United States, 362 U.S. 145, 171 n.37(b) (1960). Title 18 U.S.C. § 1346(a)(1) (1970) grants district courts jurisdiction to hear such suits.

Although Shaffer could sue for a refund after only a small payment on the assessment, he would have been unsuccessful in attempting to enjoin the collection because I.R.C. § 7421 provides that no suit to restrain the assessment of any tax shall be maintained in any court by any person. In Professional Eng'rs., Inc. v. United States, 527 F.2d 597 (4th Cir. 1975), the Fourth Circuit upheld the constitutionality of this anti-injunction statute. In *Professional Engineers,* the taxpayer contended that the Commissioner's seizure of the company's bank account for failure to pay an assessment, *see* note 1 *supra,* and the taxpayer's inability to enjoin collection were unconstitutional. The Fourth Circuit ruled that Bob Jones Univ. v. Simon, 416 U.S. 725, 746 (1974), which held that if a taxpayer had an adequate remedy at law in a refund action the anti-injunction statue was not unconstitutional, was dispositive and dismissed the suit.

Courts will permit an injunction however, if (1) the government can not prevail under any circumstances on the merits of the assessment, (2) the taxpayer does not have an adequate remedy at law, and (3) the taxpayer shows that irreparable harm would result unless the injunction is permitted. Miller v. Standard Nut Margarine Co., 284 U.S. 498, 510-11 (1932). *See* Lucia v. United States, 474 F.2d 565, 577 (5th Cir. 1973) (remanded to determine if the government's wagering tax assessment had any factual basis); Pizzarello v. United States, 408 F.2d 579, 586 (2d Cir.), *cert. denied,* 396 U.S. 986 (1969) (remanded to determine if a forced sale of the taxpayer's business would result unless an injunction were permitted).

[9] The "required records doctrine" of Shapiro v. United States, 335 U.S. 1, 34 (1948) is inapplicable to a wagerer's records. Marchetti v. United States, 390 U.S. 39, 55-57 (1968). *See* note 13 *infra.* In *Shapiro,* the Court held that a merchant's daily records were not privileged under the fifth amendment because they possessed "public aspects." In *Marchetti,* the Court distinguished a wagerer's records from a merchant's records because the wagering tax laws required gamblers to give information about their wagering activities which was unrelated to any records that they may have maintained and which lacked "public aspects," and the laws were directed at a group inherently suspected of criminal activities. *See* Edgar, *Tax Records, the Fifth Amendment and the "Required Records Doctrine,"* 9 ST. LOUIS L.J. 502 (1965); *see generally,*

tation of his gross income, claiming his privilege against self-incrimination.[10] In response to this refusal, the government moved for an order compelling discovery or, in the alternative, for judgment on its counterclaim for the balance of the assessment.[11] Ruling that Shaffer could not refuse to answer the questions and still maintain his lawsuit, the district court dismissed his complaint and entered judgment for the government.[12]

In reversing this decision, the Fourth Circuit chose not to reach the fifth amendment issue.[13] Instead, acting in its supervisory capac-

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Note, *Required Information and the Privilege Against Self-Incrimination*, 65 COLUM. L. REV. 681 (1965).

[10] Shaffer could not have refused to provide any information on the grounds of his fifth amendment privilege unless every question would tend to incriminate him. The Fourth Circuit recently denied such a blanket assertion of the privilege against self-incrimination in United States v. Harrison, Civil No. 76-1255 (4th Cir., June 29, 1976), *disposition recorded* 532 F.2d 752. In *Harrison*, the district court held the taxpayer in contempt for refusing to provide any information or documents under an I.R.S. summons despite a court order. The Fourth Circuit affirmed the contempt finding for failure to submit the documents to an in camera inspection because Harrison refused to indicate why the information would tend to incriminate him, but partly remanded the case to determine the applicability of the privilege as to each question asked. Since Harrison provided no reason why the information would tend to incriminate him, the district court would have to review the setting in which the government asked the questions and their implications to determine if an answer would subject Harrison to the danger of self-incrimination. *See* Hoffman v. United States, 341 U.S. 479, 486 (1951).

[11] 528 F.2d at 921.

[12] *See* note 3 *supra*.

[13] The court did not discuss Shaffer's fifth amendment claim that the dismissal caused a forfeiture similar to the one condemned in United States v. United States Coin & Currency, 401 U.S. 715 (1971). In *Coin & Currency*, the government instituted a forfeiture proceeding to obtain the money that a gambler, convicted for failure to register under I.R.C. § 4412, had in his possession at the time of his arrest. Applying Marchetti v. United States, 390 U.S. 39, 60-61 (1968), in which the Court held that a gambler could not be criminally punished for his failure to register, and Grosso v. United States, 390 U.S. 62, 66 (1968), in which the Court held that a claim of the self-incrimination privilege precluded a criminal conviction for failure to pay the tax because the Treasury Department did not accept payment without a properly filed return, the Court ordered the return of the money. The Court compared the forfeiture statute, I.R.C. § 7302, to a criminal fine because the statute intended to punish only persons significantly involved in criminal activity. 401 U.S. at 721-22.

The dismissal of Shaffer's suit would not fall directly under *Coin & Currency* because the government was attempting to collect only the amount due if Shaffer had complied with the law, whereas in *Coin & Currency* the wagerer could have retained the forfeiture if he had complied with the law. *See* Lucia v. United States, 474 F.2d 565, 572 (5th Cir. 1973). In addition, the government did not confiscate the wagers but only imposed a tax upon them. *See* Urban v. United States, 445 F.2d 641, 643 (5th Cir. 1971), *cert. denied*, 404 U.S. 1015 (1972). The Fourth Circuit noted that *Coin &*

ity, the Fourth Circuit instructed the lower court to defer the proceeding until the government granted Shaffer use and derivative use immunity or until the running of the applicable statutes of limitation. In this way, the court precluded the government from assessing the tax to assist its criminal prosecution.[14]

Other circuits considering this problem also have acted to avoid any confrontation with the taxpayer's fifth amendment rights. In one refund case, the court protected the government from the taxpayer's potential abuse of civil discovery to obtain information for a criminal proceeding that otherwise would be unavailable.[15]

In *Ianelli v. Long*,[16] the Third Circuit protected the taxpayer's privilege against self-incrimination by adopting the deferral remedy, which postpones the refund suit until the danger of self-incrimination has ended. In *Ianelli*, the district court ruled that the taxpayer, who was under indictment for violation of federal gambling laws, would be unable to contest a jeopardy assessment for wagering taxes and a

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Currency did not invalidate collection of the tax if the government did not punish the taxpayer in a criminal sense for asserting his privilege against self-incrimination. 528 F.2d at 922.

An alternative argument to permit Shaffer to maintain his suit is that the dismissal tended to coerce him to incriminate himself. In Spevack v. Klein, 385 U.S. 511 511 (1967), an attorney was disbarred for asserting his privilege against self-incrimination and for failing to produce personal records at a judicial inquiry into professional misconduct. The Supreme Court reversed, holding that the fifth amendment protects the right of a person to remain silent and to suffer no penalty for such silence. The Court noted that a penalty is not restricted to fine or imprisonment but means the imposition of any sanction which makes the assertion of the privilege costly.

Dismissal of Shaffer's suit would make the assertion of his privilege costly because he would have no further recourse to contest the assessment of the tax. *But see* Urban v. United States, 445 F.2d 641, 643 (5th Cir. 1971) where the court rejected such an argument. *Urban*, a wagering tax refund suit, may be distinguished, however, because the taxpayer was not under indictment for gambling charges and the statute of limitations barred prosecutions under state gambling laws, thereby making the privilege inapplicable. *See* note 35 *infra*.

[14] The differences between civil and criminal discovery indicate the need for the court's remedy. Although discovery in civil cases is based on the premise that both parties should have access to the full disclosure of relevant information, Hickman v. Taylor, 329 U.S. 495, 501 (1947), criminal discovery is very limited. FED. R. CRIM. P. 15-17. In general, the defendant may not obtain statements of government witnesses until after they testify in court, 18 U.S.C. § 3500 (1970), and the government may require the production of documents only "upon a showing of materiality to the government's case and that the request is reasonable." FED. R. CRIM. P. 16(c). *See* Note, *Criminal Procedure: Pretrial Prosecutorial Discovery and the Privilege Against Self-Incrimination*, 5 U.C.L.A.-ALAS. L. REV. 80 (1975).

[15] *See* text accompanying notes 23-24 *infra*.

[16] 487 F.2d 317 (3d Cir.), *cert. denied*, 414 U.S. 1040 (1973).

levy on his property without incriminating himself.[17] To protect against this self-incrimination, the court enjoined the government from executing its liens.[18] Although the Third Circuit agreed that any challenge to the assessment would involve incrimination, it reversed because Ianelli had an adequate remedy at law through a refund suit. Nevertheless, to protect the taxpayer's fifth amendment rights, the court instructed the district court to defer the refund suit until the conclusion of the criminal proceedings or the running of the applicable statutes of limitation.[19]

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[17] 333 F. Supp. 407, 410 (W.D. Pa. 1971). I.R.C. § 6861 authorizes the Commissioner to assess a deficiency in tax payment before sending a notice of deficiency, I.R.C. § 6212(a), if he believes that assessment on collection of the tax would be jeopardized by delay. For a summary of the assessment procedure, see note 1 *supra*.

[18] 333 F. Supp. at 412-13.

[19] 487 F.2d at 318. A protective order limiting the time and place of discovery would have the same effect as a deferral. District courts are granted power under FED. R. CIV. P. 26(c)(2) to issue such orders for good cause, which would be that the information is privileged. The rules of evidence determine whether information is privileged under FED. R. CIV. P. 26(b)(1), which prohibits the discovery of such information. United States v. Reynolds, 345 U.S. 1, 6 (1953). The order would postpone discovery in the refund suit until the conclusion of the related criminal proceeding. *See* text accompanying notes 36-39 *infra*. Nevertheless, the taxpayer should not reveal incriminating information without claiming the privilege, for he may not invoke the privilege at a later date unless he is in real danger of further incrimination. Rogers v. United States, 340 U.S. 367, 374 (1951); *In re* Master Key Litigation, 507 F.2d 292, 294 (9th Cir. 1974); *see* Garner v. United States, 424 U.S. 648 (1976) (failure to claim self-incrimination privilege on tax return precluded assertion of the privilege at trial). If the district court refused to grant the protective order, the taxpayer could request a writ of mandamus, appeal under the collateral order doctrine, or ask the criminal court to enjoin further discovery in the civil action. *See* Note, *Federal Courts—Discovery—Stay of Discovery in Civil Court to Protect Proceedings in Concurrent Criminal Action—The Pattern of Remedies*, 66 MICH. L. REV. 738 (1968).

In limiting the scope of discovery, the district court may require that the depositions, after being sealed, be opened only by order of the court. FED. R. CIV. P. 26(c)(4)&(6). To limit the government's discovery to non-privileged material in a wagering tax refund suit, however, would impair its defense seriously because knowledge of the taxpayer's wagering activity is essential to determine the correct liability. The court also might order interrogatories to be held under seal until the conclusion of the criminal proceeding, McSurely v. McClellan, 426 F.2d 664, 672 (D.C. Cir. 1970), but this limitation would do little to advance discovery because it would be the last step before a deferral of the proceedings. This procedure would, however, preserve testimony until after the deferral. The practical effect of an order to seal the depositions would be minimal because the government is a party to both actions. Although the court might prohibit the use of the information in the criminal proceeding, to control the use of leads obtained from the information would be difficult. The Fourth Circuit's remedy of use and derivative use immunity, however, does control the use of secondary evidence obtained from the disputed information because the prosecutor in a subsequent proceeding must prove that his information is untainted by evidence obtained

When confronted with this same problem in *Thomas v. United States,*[20] the Fifth Circuit did not instruct the district court on the specific remedy for the wagerer's dilemma. In *Thomas,* the government served the taxpayer with twenty-one interrogatories, ten of which the taxpayer refused to answer on the ground of his privilege against self-incrimination. The district court dismissed Thomas' refund suit despite the argument that the answers would be incriminating with regard to an action pending against him for violation of state gambling laws. The Fifth Circuit reversed, agreeing with Thomas that since his disobedience was based on his fifth amendment privilege, any sanction imposed should permit him the opportunity to prove that the assessment was erroneous.[21] The court, however, did not state a specific remedy, but left its formulation to the district court's discretion in light of *Ianelli* and *Shaffer.*[22] Nevertheless, the Fifth Circuit's ruling indicates that the taxpayer had a right to maintain his silence and his lawsuit. Moreover, the court did not rule in a supervisory capacity, as the Fourth Circuit did in *Shaffer,* but acted as a court declaring substantive law.

Although the taxpayer may need protection of his rights in civil cases, at times the government requires protection from the abuse of civil discovery by the taxpayer. In *Russell v. United States,*[23] an income tax refund suit, the taxpayer requested admissions from the government that were relevant to his appeal from a related criminal conviction. The district court granted the government's request for a deferral to prevent Russell from obtaining information through civil discovery that was not available through criminal discovery. Balanc-

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under a grant of immunity. Kastigar v. United States, 406 U.S. 441, 461-62 (1972). *See* Donnici, *The Privilege Against Self-Incrimination in Civil Pre-Trial Discovery: The Use of Protective Orders to Avoid Constitutional Issues,* 3 U.S.F.L. REV. 12 (1968).

[20] 531 F.2d 746 (5th Cir. 1976).

[21] *Id.* at 749. Although the Fourth Circuit did not discuss a due process issue in *Shaffer,* the dismissal of Shaffer's suit arguably would work as a denial of due process. The Supreme Court recognized that dismissal of the plaintiff's action in a civil suit could be a denial of due process in Societe Int'l Pour Partic. Indus. et Commerc., S.A. v. Rogers, 357 U.S. 197 (1958). There, the plaintiff was unable to produce certain documents during discovery because production would have resulted in criminal liability under Swiss law. Balancing the government's interests against those of the plaintiff, the Court held that the dismissal of the suit despite the plaintiff's good faith attempt to cooperate during discovery denied due process. *Id.* at 213. Similarly, Shaffer's assertion of his fifth amendment privilege was in good faith because of the real danger of self-incrimination. *See generally* Rendleman, *The New Due Process: Rights and Remedies,* 63 KY. L.J. 532 (1975).

[22] 531 F.2d at 750.

[23] 37 A.F.T.R.2d (P-H) ¶ 76-617 (10th Cir. Apr. 5, 1976).

ing the government's interest in preparing the appeal without the intrusions of civil discovery against Russell's interest in a prompt determination of his income tax liability, the court upheld the discretionary grant of the deferral.[24] The court may have balanced the denial of Russell's liberty against his proprietary interest in the tax. Although Russell expressly denied any claim of the privilege against self-incrimination, the court listed the protection of Russell's privilege as one of the deciding factors.

Traditionally, courts considering a motion to dismiss for failure to comply with an order compelling discovery[25] or a motion to stay a proceeding[26] balance the interests of the parties involved. In *Ianelli, Shaffer* and *Russell,* the courts balanced the interests of the government and the taxpayer but reached different solutions by emphasizing different interests. The Third Circuit in *Ianelli* was primarily concerned with the government's interest in the collection of the tax without undue judicial interference.[27] The court denied the injunction because it found that the jeopardy assessment was a bona fide attempt to collect the tax.[28] The court allowed deferral of the proposed refund suit, however, to permit the taxpayer to contest assessment without incriminating himself.[29] This remedy emphasizes the protection of Ianelli's fifth amendment privilege over his interest in a prompt determination of tax liability.[30]

The Third Circuit's deferral remedy may have been overly broad. Although the Supreme Court has affirmed the inherent power of courts to stay proceedings, the Court also noted that the stay should be restricted to a moderate time period and reinstated if necessary.[31] The Third Circuit ordered a deferral of the proceedings "until the

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[24] *Id.* at ¶ 76-1372.

[25] *See, e.g.,* Scarver v. Allen, 457 F.2d 308, 310 (7th Cir. 1972); Dorsey v. Academy Moving & Storage, Inc., 423 F.2d 858, 860-61 (5th Cir. 1970); Gill v. Stolow, 240 F.2d 669, 671 (2d Cir. 1957); Comment, *Standards for Imposition of Discovery Sanctions,* 27 ME. L. REV. 247 (1975).

[26] Landis v. North Am. Co., 299 U.S. 248, 254-55 (1936).

[27] The government contended that I.R.C. § 7421 prohibited the injunction. *See* note 8 *supra.* In Bob Jones Univ. v. Simon, 416 U.S. 725, 737 (1973), the Supreme Court stated that the purpose of the statute was to facilitate the expeditious collection of taxes with a minimum of pre-enforcement judicial interference.

[28] Ianelli v. Long, 487 F.2d 317 (3d Cir. 1973).

[29] *Id.* at 318.

[30] For a discussion of the plaintiff's interests in actions where the government is not a party, see Kaminsky, *Preventing Unfair Use of the Privilege Against Self-Incrimination in Private Civil Litigation: A Critical Analysis,* 39 BROOKLYN L. REV. 121 (1972).

[31] Landis v. North Am. Co., 299 U.S. 248, 254 (1936).

conclusion of the related criminal proceeding."[32] If the taxpayer or government appealed the decision in the criminal case, this period of time might extend for several years.[33] A more moderate solution would be to order an initial stay of proceedings until the conclusion of the criminal trial, when the stay would be reviewed if a party requested a renewal.[34] The trial court then would inspect the disputed documents or review the information in an in camera hearing to determine if the danger of self-incrimination still existed.[35] If the information had been disclosed in the criminal trial, it is difficult to see how the taxpayer could be injured by its disclosure through discovery. If the danger of incrimination remained, however, the court could extend the deferral.

By contrast, the Tenth Circuit in *Russell* valued the public interest in the criminal prosecution over Russell's interest in a prompt conclusion of the refund action. Although there is an important public interest in the enforcement of criminal laws,[36] this interest would appear to be outweighed if the taxpayer's ability to present his tax refund case is seriously impaired. The Tenth Circuit might have inquired whether the delay would affect the availability of evidence or impose an undue hardship on Russell. If the delay had had such an effect, the court could have provided that the government agree to appropriate stipulations or permit Russell to continue discovery in areas not related to his criminal case. This solution would have protected the criminal prosecution while insuring that the government's purpose for the delay was not to hinder Russell's refund suit.

In *Thomas,* the Fifth Circuit emphasized the public interest in protection from overreaching by the government.[37] The court ex-

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[32] Ianelli v. Long, 487 F.2d 317, 318 (3d Cir. 1973).

[33] In Dellinger v. Mitchell, 442 F.2d 782, 787 (D.C. Cir. 1971), the court reversed the grant of a stay in a civil proceeding related to a criminal action for this reason.

[34] Landis v. North Am. Co., 299 U.S. 248, 257 (1936).

[35] A claimant may not assert the privilege against self-incrimination when the reason for the privilege no longer exists. United States v. Goodman, 289 F.2d 256, 259 (4th Cir. 1961), *rev'g* 178 F. Supp. 338 (E.D. Va. 1959), *vacated,* 368 U.S. 14 (1961) (per curiam) (remanded to permit the government to withdraw its application for an order to compel testimony).

[36] Campbell v. Eastland, 307 F.2d 478, 487 (5th Cir. 1962), *cert. denied,* 371 U.S. 955 (1963).

[37] 531 F.2d at 749. The Supreme Court in Holland v. United States, 348 U.S. 121 (1954), expressed a similar concern and cautioned courts of appeals reviewing estimations of tax liability to bear "constantly in mind the difficulties that arise when cicumstantial evidence as to guilt is the chief weapon of a method that is itself only an approximation." *Id.* at 129. The government uses an approximation in "net worth" cases such as *Holland* because the taxpayer's records are inadequate to determine any

pressed concern that the government might calculate an excessive tax assessment and frame incriminating interrogatories to force the taxpayer to choose between maintaining his refund suit or exposing himself to criminal liability.[38] Although the court denied Thomas the use of his money during the deferral because the government had collected a part of the wagering tax assessment by seizure, the deferral permitted Thomas to contest the seizure at a later date rather than concede the validity of the assessment. If Thomas succeeded in his action, the government would pay interest on the seized money,[39] partly alleviating Thomas' loss of the use of his money. Further, the deferral allowed Thomas an opportunity to recover his money without forcing him to provide evidence that might have assisted the government in its prosecution.

The Fourth Circuit's remedy reflects a similar concern for potential governmental abuse of power through civil discovery to promote a concurrent criminal investigation. If the government granted immunity, there would be little doubt that the purpose of the assessment was to collect the tax. Refusal to grant immunity, however, would imply an attempt to coerce the taxpayer into self-incrimination. Therefore, the *Shaffer* decision indicates an interest in the integrity of the Federal Rules of Criminal Procedure relating to discovery[40] and the protections they provide for the accused.

Although the Fourth Circuit's instruction to defer the proceeding until the statutes of limitation had expired if the government

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income tax liability. To sustain its calculation, the government must establish the net value of the defendant's assets at the beginning of the tax year in question. That figure is deducted from his net worth at the end of the tax year and all non-deductible expenditures are added. The final figure is the defendant's taxable income if the government's proof either (1) negates all nontaxable sources of income or (2) demonstrates a likely taxable source which generated the income. United States v. Bethea, 537 F.2d 1187, 1188-89 (4th Cir. 1976).

The Fourth Circuit recently applied the Supreme Court's admonition in *Bethea,* holding that the government failed to prove the taxpayer's taxable income. In *Bethea,* the taxpayer testified that his deceased brother, a narcotics dealer, left a large sum of cash in Bethea's safe deposit box. The government contended, however, that Bethea used the disreputable "cash hoard" defense. *See, e.g.,* Smith v. United States, 236 F.2d 260 (8th Cir.), *cert. denied,* 352 U.S. 909 (1956) (money hidden or buried); Mighell v. United States, 233 F.2d 731 (10th Cir.), *cert. denied,* 352 U.S. 832 (1956) (buried cash). The court rejected the government's assertion because Bethea's contention was corroborated by his brother's attorney who testified that he had seen the deceased with large sums of cash, and reversed the conviction.

[38] Thomas v. United States, 531 F.2d 746, 749 (5th Cir. 1976).

[39] I.R.C. § 6611 requires that interest be paid on overpayments of tax if the refund occurs more than forty-five days after the return is filed.

[40] FED. R. CRIM. P. 15-17. *See* note 14 *supra.*

declined to grant immunity would be subject to the same criticism as the deferral remedy ordered by the Third Circuit,[41] the immunity remedy does allow the tax collection to proceed without delay. A grant of immunity, however, would force the criminal prosecutor to prove that his case was untainted by evidence obtained under the grant. Thus, the government might have to sacrifice a criminal prosecution to collect a tax more promptly. Since the government may resume the civil suit when the danger of self-incrimination has ended, it probably would decline the Fourth Circuit's invitation to grant immunity.[42]

Another criticism of the Fourth Circuit's remedy is that it is too restrictive. Under its terms, a wagerer under indictment conceivably might institute a refund action in the hope of gaining immunity. He would at least postpone payment of his full tax liability until his appeals were exhausted or the applicable statutes of limitation had expired. A remedy with greater flexibility would require the government to grant use and derivative use immunity before continuing discovery or to defer the proceeding until the conclusion of the criminal trial, with a provision for review of the deferral at that time, or to defer until the running of the applicable statutes of limitation. This remedy balances the public and private interests because it protects the taxpayer from the use of privileged information at his criminal prosecution, and provides an opportunity to conclude the refund suit within a reasonable time if the taxpayer is no longer in danger of self-incrimination.

B. Review of a Tax Court Finding that Property Was Held Primarily for Sale in the Ordinary Course of Business.

Section 7482 of the Internal Revenue Code grants the federal courts of appeals jurisdiction to review Tax Court decisions "in the same manner and to the same extent as decisions of the district

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[41] The Fourth Circuit ordered a stay of the proceedings until the government granted immunity or until all applicable statutes of limitation had run. 528 F.2d at 922. A more moderate period of time would be until the conclusion of the criminal trial, when the deferral could be reviewed. *See* text accompanying notes 31-35 *supra*.

[42] Under the Speedy Trial Act of 1974, 18 U.S.C. §§ 3152-56, 3161-74 and 28 U.S.C. § 604 (Supp. V 1975), the government must bring a defendant to trial within a limited time after his arraignment or risk dismissal of its case. Since this time progressively declines to only sixty days after July 1, 1979, the government would incur only a brief delay before resuming a related tax suit and probably will decline future similar invitations to grant immunity.

courts in civil actions tried without a jury."[1] Accordingly, the courts of appeals may not reverse the Tax Court's findings of fact unless "clearly erroneous."[2] Until recently, the Fourth Circuit had followed the clearly erroneous rule with respect to the Tax Court's finding that property was held primarily for sale in the ordinary course of business[3] and had reviewed the finding as a question of fact.[4] In *Turner v. Commissioner*,[5] however, the Fourth Circuit reversed its position and held that a finding of the taxpayer's purpose for holding the property was an ultimate fact which would be treated as a conclusion of law.[6] This holding, which resulted from the Commissioner's invitation to treat the finding as a conclusion of law,[7] permitted the court to review the decision without the restraints of the clearly erroneous rule.

In *Turner*, the taxpayer bought three tracts of land on three different occasions which he subsequently sold in three separate transactions to a development company that he had organized. Turner acquired, subdivided and improved the first two tracts with the intent that his company would develop them. In effect, Turner financed the first two purchases for his company because it lacked financial stabil-

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[1] Congress passed I.R.C. § 7482 in reaction to Dobson v. Commissioner, 320 U.S. 489, 501 (1943). In *Dobson*, the Supreme Court held that the Tax Court's conclusions of fact must be sustained if they have a rational basis. *See* REPORT OF THE WAYS & MEANS COMM. ON THE TAX REVISION ACT OF 1948, H.R. DOC. No. 2087, 80th Cong., 2d Sess. 16 (1948).

[2] FED. R. CIV. P. 52(a). Under the clearly erroneous rule, an appellate court may not reverse a finding of fact unless after a review of the evidence the court is left with the definite and firm conviction that the lower court committed an error. United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948). *See* 5A MOORE'S FEDERAL PRACTICE ¶ 52.03 at 2613-77 (2d ed. 1975); 9 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE ¶¶ 2583-91 at 725-73 (1971).

[3] I.R.C. § 1221(1) provides that property held by the taxpayer for sale to customers in the ordinary course of his trade or business is not a capital asset. Only capital assets receive capital gains treatment on gain from their disposition. I.R.C. §§ 1202, 1222(9). "Primarily" means "of first importance" or "principally." Malat v. Riddell, 383 U.S. 569, 572 (1966). *See* Bernstein, *"Primarily for Sale"; A Semantic Snare*, 20 STAN. L. REV. 1093 (1968); Rubin, *Capital Gain Treatment of Real Estate Sales: Implications of the Malat Case*, 16 TUL. TAX INST. 421 (1967); Note, *"Primarily for Sale" in I.R.C. Sections 1221 and 1231 Held to Mean "Principally for Sale" Rather Than "Substantially for Sale"*—Malat v. Riddell, 64 *Mich. L. Rev.* 1610 (1966).

[4] Industrial Life Ins. Co. v. United States, 481 F.2d 609, 610 (4th Cir. 1973) (per curiam), *aff'g* 344 F. Supp. 870 (D.S.C. 1970), *cert. denied*, 414 U.S. 1143 (1974); Tidwell v. Commissioner, 298 F.2d 864, 866 (4th Cir. 1962).

[5] 540 F.2d 1249 (4th Cir. 1976), *rev'g* 33 T.C.M.(CCH) 1167 (1974).

[6] *Id.* at 1252.

[7] *Id.*

ity.[8] Turner had no plans to subdivide the third tract at the time of purchase, and made no improvements to it; but the advent of municipal services to the tract and an adjacent farm that the development company owned made this tract ideal for development. One year after this occurrence, Turner sold the third tract to his company for cash, a promissory note and a conveyance of seventy-five acres of the farm.[9]

The Tax Court found that Turner was in the business of buying and selling real estate for subdivision and development, that all of the tracts were acquired and held in the ordinary course of this business, and that, therefore, they were not capital assets.[10] Turner acquiesced in this conclusion as to the first two tracts, but contended that the third tract was a capital asset.[11]

The Fourth Circuit agreed with Turner, concluding that he purchased the third tract as an investor and not as a dealer.[12] In reaching

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[8] The method used to sell the lots to individuals indicated Turner's close relationship to the company. Turner leased the lots to his company for 99 years at an annual rent of six percent of the redemption price. When the company sold the house which it had built on the lot, it assigned the lease to the buyer who agreed not to redeem the lease for five years, at which time he could obtain a fee simple. In consideration for this agreement, Turner reduced the ground rent to five percent for the five year period. 33 T.C.M. (CCH) at 1169. I.R.C. § 1055 permitted the homeowners to treat a qualified ground lease arrangement as a sale subject to a mortgage.

[9] The parties agreed to delay a formal conveyance for two years to facilitate rezoning the seventy-five acres for commercial use. 540 F.2d at 1254.

[10] 33 T.C.M.(CCH) at 1185.

[11] A real estate dealer may acquire land as a long term investment and treat his profit as a capital gain. Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 188 (8th Cir. 1967); Scheuber v. Commissioner, 371 F.2d 996, 998 (7th Cir. 1967). *See* Looney, *The Tax Effect of Subdividing Real Estate: Dealer or Investor?* 63 ILL. B.J. 66 (1974).

[12] Although the Fourth Circuit did not mention the factors which the courts consider to determine whether property was held in the ordinary course of business, the discussion presented in the opinion indicates that it did consider them. These factors include the purpose in acquiring the asset, the frequency, continuity, and size of the sales, the activities of the seller in disposing of the property, the extent of improvements to the property, the proximity of the sale to the purchase, and the reason the taxpayer held the property at the t time of the sale. William B. Howell, 57 T.C. 546, 554 (1972).

Courts also use these factors to determine whether a taxpayer is in the business of selling real estate. In Biedenharn Realty Co. v. United States, 526 F.2d 409, 416 (5th Cir.), *cert. denied*, 97 S. Ct. 64 (1976), the court stated that when the guidelines are used for that purpose, the most significant factors are the frequency and substantiality of the sales. Substantiality is determined from the proportion of the taxpayer's total annual income derived from the sales in question. United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969). The lack of sales promotion in *Turner* was not important because of Turner's close relationship to the company. *Cf.* Jersey Land & Dev. Corp. v. United States, 539 F.2d 311, 315 (3d Cir. 1976) (presence or lack of promotional

its decision, the court of appeals made a plenary review of the facts and focused its attention on Turner's intent when purchased the third tract.[13] Indications of Turner's intent at the time of purchase were that the tract was rural farmland and that Turner failed to improve the land before the sale.[14] These facts caused the Fourth Circuit to reverse the Tax Court's finding.

The Fourth Circuit's decision to treat the Tax Court's finding as a conclusion of law is not without support. The Fifth Circuit, in deciding whether to review the finding of purpose as a matter of law, has reasoned that the finding was based on undisputed facts and that the court of appeals could interpret and reason from those facts as well as the Tax Court.[15] The Third Circuit has noted that the question

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activity is irrelevant in commercial land transactions because the information is usually known to potential purchases).

The Fourth Circuit also held that the severty-five acres should be treated as income to Turner on the date of the agreement because he was the equitable owner at that time. The court reasoned that the sale was complete for tax purposes although legal title had not passed. In determining if a sale is complete for tax purposes, courts have considered whether the burdens of ownership have passed or alternatively whether the parties have entered a binding contract. Dettmers v. Commissioner, 430 F.2d 1019, 1023 (6th Cir. 1970), *aff'g* 51 T.C. 290 (1969) (stocks); Commissioner v. Union Pac. R.R., 86 F.2d 637, 639 (2d Cir. 1936) (real property). Establishing the date of the completed transaction in this manner prevents a taxpayer from manipulating the date of the formal closing. Such manipulation would distort income if the taxpayer delayed the formal closing until a year in which he had a low income.

[13] The Tax Court had focused its attention on Turner's intent at the time of the sale and considered Turner and his company to be "joint participants" in the development of the third tract. Viewing the third sale as part of a continuing scheme to acquire adjacent properties and enhance their value by joining and developing them, the Tax Court found that Turner's failure to improve the third tract was not attributable to any intent to hold the tract as an investment, but resulted from an external factor. The cause was Turner's inability to acquire, despite his attempts to do so, the adjacent farm that his company subsequently purchased. 33 T.C.M.(CCH) at 1184. The Tax Court considered a term in the agreement between Turner and his company which stated that the company would obtain commercial rezoning, as indicative of Turner's intent to profit eventually from the sale through the land's development rather than through its market appreciation.

In Tibbals v. United States, 362 F.2d 266 (Ct. Cl. 1966), the Court of Claims also concentrated on the purpose for which the taxpayer held the property at the time of sale, but concluded that the taxpayer sold the land as an investment because his purpose in holding the property had changed.

[14] *But see* Jersey Land & Dev. Corp. v. United States, 539 F.2d 311, 315-16 (3d Cir. 1976), where the Third Circuit stated that the purpose for holding the property at the time of sale was controlling rather than the initial purpose at acquisition. *Turner* however, may be distinguished because the taxpayer in *Jersey Land* had made extensive improvements to the property.

[15] United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969). The court stated that although the district court's finding had factual underpinnings, it was inherently

of intent is an ultimate fact or legal inference to be drawn from other facts and thus is subject to review outside the rule.[16] The Ninth and Tenth Circuits, however, consider intent to be a question of fact for the lower court,[17] and the Sixth Circuit has interpreted *Commissioner v. Duberstein*[18] as precluding plenary review of the Tax Court's finding of any ultimate fact.[19]

In *Duberstein,* the Supreme Court upheld under the clearly erroneous rule the Tax Court's finding that a transfer of property was a gift under section 102(a) of the Internal Revenue Code. The facts were not disputed; nevertheless, the Supreme Court noted that the Tax Court had applied not only legal reasoning, but also its knowledge of human experience to determine the intent of the transferor.[20] Although the Fourth Circuit did not discuss *Duberstein* in *Turner,*[21] the

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a question of law. *See* Biedenharn Realty Co. v. United States, 526 F.2d 409, 416 n.25 (5th Cir. 1976) (power to review the finding as to purpose was plenary and not limited by the clearly erroneous rule).

[16] Pennroad Corp. v. Commissioner, 261 F.2d 325, 328 (3d Cir. 1958), *cert. denied,* 359 U.S. 958 (1962). *See* note 2 *supra.*

[17] Los Angeles Extension Co. v. United States, 315 F.2d 1, 3 (9th Cir. 1963) (a review of the finding as to the purpose has little precedental value because each case must be decided on its facts). *See* Friend v. Commissioner, 198 F.2d 285, 289 (10th Cir. 1952) (purpose is essentially a question of fact). *But see* Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1189 (10th Cir. 1974) (reviewed application of Internal Revenue Code to the facts outside clearly erroneous rule because could draw needed conclusions as well as the lower court).

[18] 363 U.S. 278 (1960).

[19] Buckeye Union Cas. Co. v. Commissioner, 448 F.2d 228, 233 (6th Cir. 1971).

[20] Commissioner v. Duberstein, 363 U.S. 278, 289 (1960).

[21] In Gantt v. Unted States, 528 F.2d 354 (4th Cir. 1975), the Fourth Circuit followed *Duberstein* and refused to overturn a jury verdict reached upon correct instructions because reasonable men could reach different conclusions on the issue. The issue was whether Gantt paid guaranteed loans for his closely-held corporation, which employed him but provided no salary, primarily to protect his status as an employee rather than as an investor. Gantt had deducted his payment of the loan as a business bad debt but the Commissioner contended that the payment was a non-business bad debt, I.R.C. § 166(d)(1), subject to the $1,000 limitation of I.R.C. § 1211(b)(1) (1954) (amended 1976). The Fourth Circuit upheld the jury finding that Gantt's primary motive for the payment was not to protect his employee status. *See* Generes v. United States, 405 U.S. 93, 103 (1972) (to (deduct a loan to a corporation, an investor-employee must prove that his primary or dominant motive was to protect his employee status); Kelson v. United States, 503 F.2d 1291, 1294 (10th Cir. 1974) (business bad debt deduction denied because taxpayer loaned $199,000 to his company which provided $6,000 or less in annual salary); *but cf.* Hagan v. United States, 221 F. Supp. 248 (W.D. ARk. 1963) (deducted loss on stock purchased in customer's business to insure that customer would buy supplies exclusively from taxpayer); Geraldine R. Mann, 34 T.C.M.(CCH) 377 (1975) (employee-investor owning 50 percent of company obtained all of her income as salary); Isidor jaffe, 26 T.C.M.(CCH) 1063 (1967) (employee-investor unable to obtain like employment elsewhere).

cases are different because § 102(a) uses the term "gift" in its colloquial sense rather than as a part of common law terminology[22] whereas "primarily held for sale to customers in the ordinary course of business" in § 1221(1) is a legal term which requires a knowledge of the tax code for its interpretation.[23] Therefore, *Duberstein* is distinguishable from *Turner* because in *Turner* there is no need to rely on any unique expertise of the Tax Court.[24]

The Fourth Circuit's decision to review the finding outside the clearly erroneous rule also may be justified because the Tax Court merely applied a standard of law to undisputed facts. A court of appeals should not ignore an erroneous application of the law merely because the lower court labeled its conclusion as a finding of fact.[25] If the reviewing court clearly states why the lower court applied an incorrect standard of law, that clarification would reduce the number of appeals and avoid litigation.

The Fourth Circuit's opinion, however, did not clarify the standard of law because the court did not indicate why the Tax Court applied an erroneous standard of law. The Fourth Circuit only reviewed the facts of the case and reached a decision contrary to the

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The court also denied Gantt's contention that he was in the trade or business of promoting, organizing and dealing in corporations because he did not develop them for a fee or intend to sell them when profitable. *See* Whipple v. Commissioner, 373 U.S. 193, 202 (1963) (merely devoting one's time and efforts to a corporation is not, in itself, a trade or business); Bernard v. Commissioner, 516 F.2d 862, 864 (9th Cir. 1975) (per curiam), *aff'g* 32 T.C.M.(CCH) 297 (1973) (principal goal in enterprise was appreciation of investment); *but cf.* Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) (corporations established for limited purpose and duration or interest sold).

If Gantt had financed the company himself and organized it under I.R.C. § 1244, he could have deducted his loss from ordinary income without the $1,000 limitation of I.R.C. § 1211(b)(1) (1954) (amended 1976). Section 1244 permits the deduction of a loss on the stock on a properly organized small company to be deducted as a loss from a non-capital asset. *See* J. Paul Smyers, 57 T.C. 189, 198-99 (1971); *but cf.* Hollenbeck v. Commissioner, 422 F.2d 2 (9th Cir. 1970) (plan disqualified because pre-existing notes held to be capital); Raymond G. Hill, 51 T.C. 621, 629 (1969) (corporation's payment of guaranteed loan was to relieve taxpayer of personal liability); Taylor *Section 1244: Avoiding its Problems,* 29 N.Y.U. INST. TAX. 201 (1971); Smith & Tannenbaum, *Second Circuit defines components of a well written plan under Section 1244,* 29 J. TAX. 66 (1968); Note, *Federal Taxation—Failure to Obtain Ordinary Loss Deduction for Section 1244 Stock,* 45 TUL. L. REV. 642 (1971).

[22] Commissioner v. Duberstein, 363 U.S. 278, 285 (1960).

[23] *See* note 3 *supra.*

[24] *See* Haverly v. United States, 374 F. Supp. 1041, 1044 (N.D. Ill. 1974) (*Duberstein* concerned meaning of "gift" exclusively), *rev'd on other grounds,* 513 F.2d 224 (7th Cir.), *cert. denied,* 423 U.S. 912 (1975).

[25] Ritter v. Morton, 513 F.2d 942, 949 (9th Cir.), *cert. denied,* 423 U.S. 947 (1975); *see* text accompanying note 15 *supra.*

Tax Court's decision. As a result, the decision merely tended to blur the division of responsibilities between the Tax Court and the courts of appeals because the lower courts often must use legal reasoning even to find evidentiary facts.[26]

C. Denial of Interest Deduction for the Repurchase Premium Paid on Securities Having Characteristics of Both Bonds and Stock.

Although a corporation may deduct as an interest expense a repurchase premium paid on a bond,[1] it may not deduct a repurchase premium paid on stock.[2] In *Richmond, Fredericksburg & Potomac Railroad Co. v. Commissioner,*[3] the Fourth Circuit considered whether the repurchase premium paid on securities having characteristics of both bonds and stock could be deducted as an interest expense. The court held that the premium could not be deducted because it was attributable to the stock characteristics of the securities.[4]

In *Richmond Railroad,* the taxpayer had issued securities during the nineteenth century which had attributes of both bonds and stock. The securities resembled bonds in that they entitled their holders to a fixed interest payment or "guaranteed dividend," which was payable regardless of earnings and which was secured by first liens on the railroad's property. The securities, however, also carried the same voting rights as common stock, and if common stock dividends equalled the "guaranteed dividends," common stockholders and security holders shared equally in additional distributions. Furthermore, in the event of dissolution the security holders would share ratably in the assets after the common stockholders received par value for their shares.

From 1962 to 1964 the Railroad repurchased some of the hybrid

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[26] Note, *Rule 52(a): Appellate Review of Findings of Fact Based on Documentary or Undisputed Evidence,* 49 VA. L. REV. 506, 527-28 (1963). *See generally* 9 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE ¶¶ 2587-89 at 740-59 (1971); 5A MOORE'S FEDERAL PRACTICE ¶ 52.03 at 2613-77 (2d ed. 1975); Weiner, *The Civil NonJury Trial and the Law Fact Distinction,* 55 CALIF. L. REV. 1020 (1967).

[1] I.R.C. § 163.

[2] I.R.C. § 311 provides that a corporation may not recognize a gain or loss on the distribution of property for its stock. Treas. Reg. § 1.311-1(a), T.D. 7209, 1972-2 C.B. 204, 206-07, provides that § 311 includes distributions made in the redemption of stock and I.R.C. § 317(a) provides that "property" includes money.

[3] 528 F.2d 917 (4th Cir. 1975).

[4] *Id.* at 919.

securities at prices far in excess of their face value[5] and claimed a deduction for the excess of the purchase price over the par price as a bond premium.[6] The Fourth Circuit held that whether the securities were debt or equity for the purposes of the Internal Revenue Code depended upon the provisions of the securities most relevant to the transaction.[7] Concluding that no bond, no matter how well secured, would sell for six times its face value, the court denied the interest deductions, reasoning that the high premium reflected the right of security holders to participate in earnings, a normal characteristic of stock. In addition, the hybrid securities lacked a fixed maturity date and sinking fund reserve, which are standard characteristics of corporate debt.[8]

The Fourth Circuit also denied two other contentions that the railroad presented; first, that the repurchase was analogous to the reacquisition of convertible bonds and therefore the premium was deductible without allocation to the stock characteristics;[9] and sec-

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[5] The face value of the hybrid securities was $25. The railroad paid an average of $112, $118 and $164 per share for the securities acquired in 1962, 1963 and 1964, respectively. *Id.* at 919.

[6] The railroad also claimed an interest deduction for the dividends paid in excess of the "guaranteed dividend." The court denied this deduction because the securities were stock in regard to this dividend payment. *See* text accompanying notes 7-8 *supra.* In an earlier case involving the same securities, Helvering v. Richmond, F. & P.R.R., 90 F.2d 971, 975 (4th Cir. 1937), the court permitted the railroad to deduct the "guaranteed dividends" as interest on debt because the securities were bonds for the purposes of that payment. The court emphasized the holder's priority over secured creditors to the corporate assets in the event of dissolution, and noted that the "guaranteed dividends" were payable whether earned or not. The dividends paid in excess of guaranteed portion, however, were paid only if earned.

[7] Other courts have considered a similar problem in determining whether instruments were debt or equity. In Austin Village, Inc. v. United States, 432 F.2d 741, 744 (6th Cir. 1970), the Sixth Circuit listed the normal provisions of a debt instrument as an unconditional promise to pay, a fixed maturity date, an interest rate and schedule for repayment, a security provision, and a sinking fund to provide funds for repayment. In *Richmond Railroad,* although the securities had only an interest rate and security provision, the absence of the other provisions was less important in construing the securities to be stock for the purposes of the transaction than the presence of a right to participate in current earnings in the manner of a common stockholder. *See* McCullers, *Debt/Equity Classification Standards,* 48 TAXES 482 (1970).

[8] Nevertheless, even if the securities had contained these provisions, the court probably would not have changed its decision but would have compared the guaranteed premium, $1.75 per share in 1964, to the dividend attributable to current earnings, $4.25 per share in 1964, and concluded that the security holders demanded such a high price for their securities because of their right to participate in current earnings.

[9] In 1964, when the railroad repurchased the securities, a company could deduct the entire repurchase premium on a convertible bond without allocating the premium between the interest payable under the bonds and their conversion feature. The Fourth

ond, that even if the securities were stock, the railroad could deduct the premium as an ordinary and necessary business expense[10] because the repurchase facilitated management of the railroad property by removing the first liens of the securities on that property. The court rejected the first argument, finding that the securities were not analogous to convertible bonds because the securities entitled their holders to vote as a common stockholder and participate in current earnings, whereas a convertible bondholder might partake of these benefits only after the conversion. As to the second argument, the deduction of the premium as a business expense would require a showing of "dire necessity,"[11] a requirement which the railroad did not meet

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Circuit allowed such a deduction without allocation in Head Ski Co. v. United States, 454 F.2d 732 (4th Cir. 1972) (per curiam), *aff'g* 323 F. Supp. 1383 (D. Md. 1971), for a repurchase that occurred before 1969. In 1969, Congress enacted I.R.C. § 249 which requires a company which repurchases a convertible bond to allocate the premium paid for the convertible bond between the payment for interest and the payment attributable to the conversion feature. Congress passed I.R.C. § 249 in reaction to Roberts & Porter, Inc. v. Commissioner, 307 F.2d 745 (7th Cir. 1962), where the court allowed a deduction of the entire premium. *H.R. Rep. No.* 91-143, 91st Cong., 1st Sess. 111 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1759-60.

The railroad may have committed a tactical error in failing to contend that even if the entire repurchase premium were not deductible, at least that portion attributable to the interest payments under the securities bond characteristics was deductible. The Fourth Circuit emphasized that the right to participate in current earnings was the most important reason for the high repurchase price, so it might have permitted the railroad to use the ratio of the "guaranteed dividend" to the total distribution as a reasonable allocation. For the seven percent securities in 1964, the "guaranteed dividends" were twenty-five percent of the total distribution. 528 F.2d at 919. This percentage would have permitted a significant deduction for the railroad. On the other hand, if the court used the computation that the Treasury Regulation for § 249 employs to determine the amount of the repurchase premium attributable to the interest feature of convertible bonds, an amount limited to the interest payable in one year, Treas. Reg. § 1.249-1(d)(2) (1973), the railroad would have been limited to a $1.75 deduction per security. Since the repurchase premium varied between $118 and $164, this computation would not result in a significant deduction.

[10] I.R.C. § 162 requires that a deductible business expense be both "ordinary and necessary." The Supreme Court has noted two ways that a taxpayer may prove an expense is "ordinary," either by showing that the expense is normal, usual or customary for the taxpayer, or, if it occurs but once in a taxpayer's lifetime, that the transaction causing the expense was a common or frequent occurrence in the type of business involved. Deputy v. duPont, 308 U.S. 488, 495 (1940). Even if the railroad's expense were ordinary because it occurred in three successive years, it was not "necessary" because it did not arise from a "dire necessity." *See* text accompanying note 11 *infra.*

[11] The court required such a showing because the railroad attempted to use an exception to I.R.C. § 311 which provides that a corporation may not recognize a gain or loss on the distribution of property for its stock. Dire necessity means that the company could not continue its operations unless it incurred the expense. H.&G.