UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
THEODORE V. OLSON and	)	
SANDRA ANN OLSON,	)	CASE NO. BK85-1085
	)	
DEBTOR	)	A86-0171
	)	
THEODORE V. OLSON and	)	
SANDRA ANN OLSON,	)	
	)	CH. 11
Plaintiff	)	
vs.	)	
	)	
UNITED STATES OF AMERICA,	)	
Department of Internal Revenue,	)	
	)	
Defendant	)	

MEMORANDUM

Trial of this adversary proceeding was held on September 4-7 and 11-14, 1990, and November 6-9, 13 and 14, 1990. Post-trial briefs and written arguments were eventually submitted by both parties and the Court took the matter under advisement in October of 1991. The plaintiffs were represented by Robert Creager of Berry, Anderson, Creager & Wittstruck, P.C., Lincoln, Nebraska. At trial the Internal Revenue Service was represented by Robert Metcalf of the United States Department of Justice. Shortly after the trial was completed, Mr. Metcalf was called into military service and the post-trial briefs and final arguments were submitted by Virginia Cronan Lowe and Susan M. Henderson of the United States Department of Justice Tax Division.

This adversary proceeding was brought by the debtors pursuant to 11 U.S.C. § 505 for a determination of tax liability. This is a core proceeding as defined in 28 U.S.C. § 157(b)(2)(B). The parties have agreed that if the adversary proceeding is not a core proceeding, the Bankruptcy Judge may enter final judgment pursuant to 28 U.S.C. § 157(c)(2). This memorandum contains the findings of fact and conclusions of law required by Fed. Bankr. R. 7052.

Introduction

Theodore and Sandra Olson filed this Chapter 11 case in 1985. In 1986, they filed the adversary proceeding against the

Internal Revenue Service (IRS) pursuant to 11 U.S.C. § 505 to determine their federal income tax liability for various years. Taxes allegedly owed included an "assessment" against Theodore Olson as a responsible officer for certain "trust fund" taxes of Olson Bros. Manufacturing Co. (OBMC); "assessments" against Theodore and Sandra Olson for individual income taxes for the years 1976, 1977 and 1978 as the result of an audit; and proposed adjustments based on a proof of claim filed by the IRS for individual income taxes for 1979, 1980, 1981, 1982 and 1983, made after audit.

In a related adversary proceeding, this Court determined Theodore Olson's liability as a responsible officer for certain "trust fund" taxes of OBMC. See Overland Nat'l. Bank v. Olson, 101 Bankr. 128 (Bankr. D. Neb. 1988) and 101 Bankr. 134 (Bankr. D. Neb. 1989) aff'd. Neb. Bkr. 91:592 (D. Neb. 1991).

The remaining income tax issues were divided and tried to the Court in two separate proceedings.

The parties and the Court agreed that after the Court enters findings of fact and conclusions of law pursuant to this memorandum, the parties will attempt to stipulate on the actual income tax computation based upon the findings of the Court. If there remains a disagreement as to the actual tax that will result from the Court's findings, the parties will request the Court to set a final hearing to resolve any remaining contested tax issues.

Therefore, the filing of this memorandum opinion does not constitute a final order on the tax issues presented in this adversary proceeding. A final order will be entered after the completion and submission of the tax obligations determined by the parties pursuant to this memorandum.

Background

There are numerous persons and entities with the name of Olson in this case. Theodore and Sandra Olson are the debtors and plaintiffs in this adversary proceeding. They will be referred to as Ted or as Sandra. Carroll Olson is Ted's brother and was involved in some of Ted's business activities. He will be referred to as Carroll. His wife is Carol Olson. She will be referred to as Mrs. Carol Olson. Olson Bros. Manufacturing Co. will be identified as OBMC. Ted Olson Enterprises, Inc., will be referred to as TOEI. The farming operation run by Ted and Sandra will be identified as Olson Farms.

Ted and Sandra are husband and wife. They were engaged in the farming and cattle business in Holt County, Nebraska, as Olson Farms. They used the services of Dana Cole & Co., certified public accountants, to keep their books and records and to prepare and file most of their tax returns.

Ted was the president of OBMC and the president of TOEI. OBMC was involved in the manufacture of center pivot irrigation systems. TOEI was formed in 1976 to perform the custom farming operation for Olson Farms. TOEI was capitalized by transfers of farming equipment from the Olsons.

Ted owned 50 percent of the stock of OBMC. His brother, Carroll, and Mrs. Carol Olson owned the other 50 percent. Carroll was an officer and equally participated in the business affairs of OBMC. In December of 1980, OBMC filed for relief under Chapter 11. Ted was later removed from the company and replaced by an operating trustee.

Olson Farms, OBMC, and TOEI were separate entities. OBMC and TOEI were closely held corporations. The corporations were treated by the Olsons' accountants and the IRS as "related parties" to Ted and Sandra under 26 U.S.C. § 267(a)(2). Ted and Sandra timely filed their U.S. individual income tax returns (Forms 1040). The federal income tax returns of Ted and Sandra for 1976 through 1983 were audited by the examination division of the IRS.

On December 21, 1982, a statutory notice of deficiency was sent to Ted and Sandra for the taxable years 1976, 1977 and 1978. On July 30, 1984, a delegate of the Secretary of the Treasury made assessments against Ted and Sandra for unpaid federal income taxes, penalties and interest as follows:

YEAR	TAX ASSESSED	TAX DUE	PENALTY TO PETITION DATE	INTEREST TO PETITION DATE
1976	7-30-84	$465,650.56	$26,565.26	$533,749.57
1977	7-30-84	261,602.56	26,160.26	276,061.21
1978	7-30-84	63,837.12	6,383.71	62,235.72

For the remaining taxable years covered by this adversary proceeding, the IRS has proposed certain federal income tax deficiencies, plus penalties and interest as follows:

YEAR	TAX ASSESSED	TAX DUE	INTEREST TO PETITION DATE
1979	Sec. 362	$512,131.00	$447,190.01
1980	Sec. 362	41,380.00	29,482.61
1981	4-15-85	4,101.00	551.53
1982	Sec. 362	120,172.00	33,530.62
1983	Sec. 362	246,520.00	32,961.06

Except for the small amount of the adjustment which was assessed on April 15, 1985, for the tax year 1981, no other "assessments" were issued for years 1979, 1980, 1981 or 1983.

All of the claims relate to the tax treatment of various forms of income and/or expenses claimed by Ted and Sandra on their tax returns.

Burden of Proof

In tax cases, an assessment, properly made by the designated representative of the Department of Treasury, is presumed to be correct. Welch v. Helvering, 290 U.S. 111, 54 S. Ct. 8 (1933). Although an assessment is presumed to be correct, the IRS must show that the assessment is reasonably based upon facts in the record. DiMauro v. United States, 706 F.2d 882 (8th Cir. 1983).

Once the IRS shows that the assessment is reasonably based upon facts, the burden of persuasion shifts to the taxpayer. It is the taxpayer's duty to present, by a preponderance of the evidence, sufficient facts to show that the assessment was erroneous in some respect. United States v. Pomponio, 635 F.2d 293 (4th Cir. 1980).

If the taxpayer presents sufficient facts to overcome the presumption of correctness afforded the assessment, such presumption disappears and the IRS is required to prove the accuracy of its determination. Jones v. Commissioner, 903 F.2d 1301, 1304 (10th Cir. 1990); United States v. Janis, 428 U.S. 433, 442; 96 S. Ct. 3021, 3026 (1976).

The proposed adjustments for 1976, 1977 and 1978 are the result of assessments made by the IRS (Exhibit 205). Therefore, the initial IRS burden is met if it demonstrates that the assessments were duly issued, and presents evidence that the determinations were reasonably based upon facts.

The proposed adjustments for 1979, 1980, 1981, 1982 and 1983 are unassessed. Therefore, there is no presumption of validity as to those adjustments. With regard to these adjustments, if this were not a bankruptcy case, the IRS and the debtor would carry the same burden of proof as would be required in any other tax case. It is the traditional rule that the burden is always on the taxpayer to prove that it is entitled to a deduction. Wisely v. United States, 893 F.2d 660 (4th Cir. 1990); IRS v. Levy, 130 Bankr. 28 at 32 (E.D. Va. 1991).

This is a bankruptcy case and not an ordinary civil tax proceeding. The burden of proof with regard to a claim is ultimately upon the claimant. The IRS has filed a claim for taxes, some of which have been "assessed" and some of which have not. Fed. Bankr. R. 3001(f) provides that a properly filed proof of claim constitutes prima facie evidence of the validity and amount of the claim. When a debtor files an objection to the claim, the evidentiary burden of Fed. Bankr. R. 3001(f) requires the objecting party to go forward with evidence contradicting the validity or amount of the claim. Global Western Dev. Corp. v. Northern Orange County Credit Serv., Inc. (In re Global Western Dev. Corp.), 759 F.2d 724, 727 (9th Cir. 1985).

Once the objecting party presents sufficient evidence to overcome the prima facie effect of the proof of claim, the ultimate burden of persuasion rests upon the claimant. IRS v. Levy, 130 Bankr. 28 (E.D. Va. 1991); In re Leedy Mortgage Co., 111 Bankr. 488, 491 (Bankr. E.D. Pa. 1990); In re Hough, 4 Bankr. 217, 219 (Bankr. S.D. Cal. 1980); In the Matter of Texlon Corp., 28 Bankr. 525, 528 (Bankr. S.D.N.Y. 1983); In re Imperial Corp. of America, 1991 WL 281712 (Bankr. S.D. Cal.).

The fact that the claimant is a tax authority does not alter the rule that the claimant bears the ultimate burden of establishing its claim. See In the Matter of Fidelity Holding Co. Ltd., 837 F.2d 696, 698 (5th Cir. 1988); In re Brady, 110 Bankr. 16, 18 (Bankr. D. Nev. 1990); In re Gran, 108 Bankr. 668, 673-74 (Bankr. E.D. Ark. 1989), aff'd. 131 Bankr. 843 (E.D. Ark. 1991).

The ultimate burden of persuasion in this case is upon the IRS on each issue. As each issue is discussed, the Court will make specific reference to the burden of proof with regard to the assessment, the claim itself and the evidence adduced by each party in support of their burden.

Procedure

The parties tried this case issue by issue. That is, they agreed that a particular adjustment for a particular year was the subject matter of the evidence which would be next presented. They then presented evidence, both in the form of documents and testimony, on a particular issue. There was direct and cross examination on that issue and then the parties moved on to the next issue. The Court will structure this memorandum in the same manner. The issue will be identified by heading and the facts and law applicable will be discussed under that heading. A conclusion with regard to that issue will be separately stated. Each issue will be dealt with in the same manner and at the end of the memorandum a summary of the adjustments, if any, for each year will be presented.

Findings of Fact, Conclusions of Law and Discussion

Issue 1.

Machine hire expenses for the 1977 and 1978 taxable years.

As part of the notice of deficiency issued to Ted and Sandra on December 1, 1982, the IRS determined that the federal income tax returns of Ted and Sandra for 1977 and 1978 should be adjusted to reflect additional income of $384,500.00 and $226,409.00, respectively, due to the disallowance of certain machine hire expenses claimed by the plaintiffs on Schedule F (Farm Income and Expense) forms attached to their federal income tax returns. The amounts of the "machine hire" expenses claimed by the plaintiffs on their Schedule F for 1977 and 1978 were, respectively, $841,059.00 and $273,124.00, and were allegedly paid to TOEI and others in connection with the custom farming performed by those entities for Ted and Sandra.

TOEI was formed by Ted in 1976. He capitalized the corporation by contributing farm equipment owned by Olson Farms. His children became shareholders in the corporation and operated TOEI and thereafter performed custom farming operations for Olson Farms. At the time, Ted and Sandra farmed approximately 4,000 acres.

When TOEI was formed in 1976, it had no operating capital and Ted advanced funds for operations. There was no written agreement between Ted and TOEI.

There is no dispute that TOEI and others actually did perform custom farming operations in 1977 and 1978 for Olson Farms. The matter at issue is how much of the money that was transferred from Ted to TOEI was in payment for the services rendered by TOEI to Olson Farms.

The accountant who prepared the tax returns testified that at the time the returns were prepared he had checks from Ted to TOEI as substantiation for the "machine hire" expenses. There was no other documentation presented. He did not, contemporaneously with the preparation of the tax return, reconcile the books of TOEI, reflecting income, with the books of Olson Farms reflecting expenses, or with the tax return of Ted and Sandra.

At the time of the audit, a document was prepared by the accounting firm which purported to "reconcile" the payments made by Ted to the receipts shown by TOEI. At trial, there was dispute over whether or not the accounting firm employee who prepared the "reconciliation" had authority to do so or had authority to share his work product with the IRS auditor. There was also a dispute over whether the "reconciliation" was ratified by the appropriate officials of the accounting firm and/or Ted as representing the true state of the books of Ted and TOEI. The Court did not admit the "reconciliation" as substantive evidence of the difference between the payments deducted by Ted and the income shown by TOEI. However, the "reconciliation" was admitted for the limited purpose of showing that the auditor had reviewed the "reconciliation" and had based the audit adjustments on the amounts shown by the "reconciliation" as paid by Ted and actually reflected in income by TOEI.

Ted and Sandra were on a cash basis for accounting and tax return preparation and operated on a calendar year for tax purposes. TOEI operated on a fiscal year which was different from the calendar year. The auditor testified that he reviewed the books of Ted and Sandra and TOEI for a sufficient number of years to track payments from Ted to TOEI and determine whether TOEI, in any, or all, of the years had reflected the payments as income. He concluded that the total amounts deducted by Ted and Sandra for "machine hire" expense in 1977 and 1978 were not reflected as income in any or all of the corresponding fiscal years of TOEI. He, therefore, adjusted the deductions by permitting Ted and Sandra to deduct only the amounts actually reflected as income by TOEI.

The tax returns of Ted and Sandra and TOEI are in evidence. The returns of TOEI do not reflect as total income an amount equivalent to that which was deducted by Ted and Sandra.

Many of the checks issued by Ted to TOEI have written upon them the term "loan." Ted explained that when TOEI began operations, it had no money. He, therefore, loaned money to TOEI to permit TOEI to perform the custom farming. At the end of each year, according to Ted, there was an adjustment made by Ted in his individual capacity and Ted in his capacity as president of TOEI, and his accountants, to assure that the books balanced. Eventually, the checks were written with a three digit number in the memo section of the check which reflected "machine hire" rather than loans.

Ted's testimony is basically contradicted by the accountant and the tax returns. Even though he claims there was an adjustment process at the end of the year, the tax returns show more expenses being deducted by Ted than income being reflected by TOEI.

The testimony by Ted seems to be that once TOEI was created, it performed all farming activities for Olson Farms. However, the tax returns of Ted and Sandra reflect farm expenses for fertilizer, seed, labor, repairs, feed, fuel and other farm type expenses at the same time that Ted and Sandra deducted "machine hire" expenses, which are now characterized as "custom farming" expenses.

During part of Ted's testimony he admitted that certain improvements were made to the farm and that some of the checks to TOEI could have been for construction of those improvements. In addition, he admitted some of the payments could have been for providing overall capital to TOEI.

The reliance by the auditor upon the written "reconciliation" and the review of deductions by Ted and Sandra versus income of TOEI is reasonable. The books should have balanced, and they did not. One can argue, as Ted does, that if books are wrong, perhaps it is TOEI's books that are wrong and not Ted's. However, Ted claims the deduction and it is Ted's obligation to prove his entitlement to a tax deduction. Burnet v. Houston, 283 U.S. 223, 51 S. Ct. 413 (1931); Lukovsky v. Commissioner, 692 F.2d 527, 528 (8th Cir. 1982).

The assessment is presumed correct. The IRS has a reasonable factual basis for the assessment. The debtor has not substantiated all of the deductions. The tax returns of Ted and TOEI reflect different expenses and income. Ted admits that some money went to TOEI for construction of improvements on the farm and, perhaps, for general capital contributions. Ted had no substantiation for the "machine hire" deductions at the time the tax return was prepared, at the time of the audit, or now. Ted's expert witness testified that a check which purported to be payment of an expense would be evidence only of the amount and not the type of expense. The checks were not in 1977 and 1978 and 1979 adequate substantiation for the deduction and they are not now adequate substantiation.

The Court concludes that Ted and Sandra have failed to meet their burden to overcome the presumption of validity of the assessment made by the IRS. Therefore, the tax returns of Ted and Sandra for 1977 and 1978 should be adjusted to reflect additional income of $384,500.00 and $226,409.00 respectively due to the disallowance of certain of the "machine hire" expenses claimed by Ted and Sandra on Schedule F for those years.

Issue 2.

Rent Expenses for the 1976 Taxable Year.

The IRS had proposed an adjustment to rent expenses for the 1976 taxable year. Evidence was adduced at trial on the issue. However, following trial, the parties settled on that issue. The Olsons are entitled to the deduction for rent expense in 1976 as set forth on their 1976 Form 1040 individual income tax return and no adjustment is required.

Issue 3.

Fertilizer Expenses for the 1977 Taxable Year.

The notice of deficiency proposed an adjustment for fertilizer expense for the 1977 taxable year. Although evidence was adduced at trial on the issue, the parties have settled post trial. Therefore, the Olsons are entitled to the deduction for fertilizer expenses in 1977 as set forth on their 1977 Form 1040 individual income tax return.

Issue 4.

Freight Income for the 1976 Taxable Year.

In the statutory notice of deficiency, the IRS determined that the federal income tax return of the debtors for the 1976 taxable year should be adjusted to reduce the taxable income of Ted and Sandra in the amount of $33,441.81. The parties agree that this proposed adjustment is proper, and the taxpayers are entitled to an adjustment to reduce their taxable income in 1976 by $33,441.81.

Issue 5.

Miscellaneous Income Received for the 1976 Taxable Year.

The statutory notice of deficiency determined that the federal income tax return of Ted and Sandra for the 1976 taxable year should be adjusted to reduce the taxpayers' taxable income in the amount of $2,000.00.

The parties agree that Ted and Sandra are entitled to an adjustment to reduce taxable income for the year 1976 by $2,000.00.

Issue 6.

Income Received from Southwest Farms for the 1978 Taxable Year.

Ted Olson was a part owner of an entity in Texas that owned land used for farming. The entity was called Southwest Farms. In December of 1978, Ted Olson traveled to Texas and he and the other owners of Southwest Farms agreed to purchase thirty-five center pivot irrigation systems from OBMC. Southwest Farms transferred, by wire transfer, $100,000.00 to Ted's personal checking account on December 20, 1978. On that same date, Ted wrote a check to OBMC. The check did not refer to a Southwest Farms contract, but stated, in the memo section, "on note." On Ted's books, the check was initially treated as a payment on note obligations he had, in his personal capacity, to OBMC. On OBMC's books, it was shown as a credit to Ted Olson.

In mid-January, 1979, a written agreement was entered into between Southwest Farms and OBMC for the purchase of thirty-five center pivot irrigation units. The contract reflected a $100,000.00 down payment, with the balance to be carried on certain terms.

Prior to filing the 1978 tax return, Ted's books were adjusted by the accounting firm. The accounting firm recognized that the $100,000.00 check should not be treated as income to Ted because he was simply a conduit to OBMC. After the adjustment was made to Ted's books, the 1978 tax return was filed and did not include the $100,000.00 check as income. However, at the time of the audit which was completed in early February of 1981, the appropriate adjustment had not been made on the books of OBMC.

The IRS auditor testified that when making the proposed adjustment to Ted and Sandra's tax liability for 1978, he reviewed the books of OBMC. The payment to OBMC was still reflected as a reduction of a note receivable on Ted's account. He, therefore, treated such reduction as income to Ted.

Ted and his expert witness testified that OBMC books were eventually corrected. However, no documentary evidence was presented of such correction. OBMC filed a Chapter 11 petition in late 1980 and Ted was removed as president, with a trustee appointed some time in 1981. Ted claims that he was unable to obtain copies of the corporate records to show that the appropriate adjustments were made because the records were not then and are not now available to him. His testimony is directly contrary to that of the auditor. Ted was still the president of OBMC during 1980 and early 1981 when the audit was completed. The books of the corporation were available to him until he was removed by the Bankruptcy Court.

Ted received a check for $100,000.00 from Southwest Farms for something. His testimony is consistent with the contract. The contract, which is in evidence, acknowledges receipt of $100,000.00 as a down payment. At that point, OBMC had to include the $100,000.00 down payment and the balance of the contract as income. Therefore, if it also included the $100,000.00 payment as a reduction of Ted's note, it is likely that the books of OBMC did not balance. There is no evidence that Ted was in direct control of the accounting process at OBMC or that he directed those in charge of the accounting process to apply the check to his notes.

Section 61 of the Internal Revenue Code, 26 U.S.C., defines gross income as "all income from whatever source derived," except as specifically excluded therefrom under other provisions of the Internal Revenue Code. The Supreme Court has long recognized that income is taxed to the person who earns it, regardless of any arrangement made to divert the payment. Lucas v. Earl, 281 U.S. 111, 50 S. Ct. 241 (1930). The assessment of the Commissioner of Internal Revenue is presumptively correct. The burden of proof is on the taxpayer to overcome this presumption. Paschal v. Blieden, 127 F.2d 398, 401 (8th Cir. 1942). In order to rebut the presumption that the Commissioner's determination of deficiency is correct, taxpayers must come forward with competent and relevant evidence. Sandvall v. Commissioner, 898 F.2d 455, 458 (5th Cir. 1990).

Ted and Sandra have presented competent and relevant evidence with regard to this issue. OBMC contracted to sell thirty-five center pivot irrigation systems to Southwest Farms in January of 1979. The contract was executed with an acknowledgement that $100,000.00 had been received as a down payment. Ted testified that he received the $100,000.00 and on the same day that he received it he wrote a personal check to OBMC. On that check was a memo "on note." At the time the check was delivered to OBMC there was no written contract of sale in existence. All of the terms had not been agreed upon, but within less than thirty days from the receipt of the $100,000.00 by both Ted and, then, by OBMC, the written contract was executed. The contract provided for payment on an installment basis as units were delivered.

The evidence is convincing that the initial payment by Southwest Farms to Ted was not income earned by Ted. It was money to be delivered by Ted, a part owner of Southwest Farms, to OBMC on a contract for purchase of products manufactured by OBMC. The fact that OBMC misapplied the payment to Ted's account and then recognized the same payment in the contract does not require the IRS or the Court to force Ted and Sandra to recognize $100,000.00 of income which they did not earn.

The debtors have met their burden of overcoming the presumption of correctness of the assessment. The IRS has not met its burden of proving the legitimacy of the adjustment by a preponderance of the evidence.

Therefore, the 1978 tax return of Ted and Sandra is not required to be adjusted to reflect an increase of $100,000.00 in income.

Issue 7.

Deductions for Tax Shelter Losses

During the years in question, Ted and Sandra invested in certain tax shelters. They claimed deductions on their tax returns for losses in those investments. Following the audit, the IRS disallowed all of the deductions for such losses. The parties have stipulated that the tax shelter was not properly qualified and the deductions claimed by Ted and Sandra should be disallowed. However, Ted and Sandra claim that they should be allowed to deduct their out-of-pocket losses in those investments.

The parties have stipulated that Ted and Sandra contributed $50,000.00 to Mountain View Associates in 1976; $36,000.00 to Hayes Associates II in 1976; and $20,000.00 to Theodore V. Olson Grantor Trust. As a result of a national settlement over the validity of these particular investments, all taxpayers who administratively appealed the disallowance of losses generated by the investments were entitled to deduct their "out-of-pocket losses" on the investment.

Ted and Sandra did not administratively appeal. The disallowance of the deduction was dealt with by the IRS in the deficiency determination and was "assessed." The determination to disallow the entire deduction is presumptively valid. Ted and Sandra claim that it is unfair to prohibit them from deducting their "out-of-pocket" losses when every other taxpayer that was similarly situated and "protested" the disallowance of the investments was permitted to deduct the out-of-pocket expense. They feel that just because they did not go through the administrative appeal process, but filed a bankruptcy case and sued the IRS for a determination of their tax liability by a bankruptcy judge, they should not be "discriminated against" and left out of the national settlement. Ted and Sandra believe it is extremely unfair to prohibit them from deducting the losses when Carroll Olson and Mrs. Carol Olson had invested in exactly the same tax shelters at exactly the same time and, because they administratively appealed rather than file bankruptcy, they were permitted to deduct their out-of-pocket expenses.

As a matter of law, the losses are not deductible under 26 U.S.C. § 704(d) in that Ted and Sandra have not shown there was sufficient basis or amounts at risk to allow a deduction of all losses as claimed. Section 162 and Section 212 of the Internal Revenue Code (26 U.S.C.) require that if an activity is not engaged in for profit then no deduction attributable to such activity shall be allowed, with certain specified exceptions which are not applicable. Since these taxpayers have not met the requirements that the activities were entered into for a profit, in that the activities were entered into primarily to reduce their income taxes by creating artificial losses and deductions, the losses are not allowed as a deduction. Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966).

Ted and Sandra have provided no legal authority for their position. The Court has found no statute, rule, or administrative procedure which limits the IRS at various administrative levels to negotiate a settlement with a taxpayer with regard to a particular issue. The fact that the IRS settles with one particular taxpayer or with thousands of taxpayers on a particular issue does not estop the IRS from litigating all issues with the taxpayer who pursues his claim in court.

Therefore, the adjustments proposed by the IRS for tax shelter losses and represented by an "assessment" are valid and upheld. The federal income tax return of Ted and Sandra for the taxable years of 1976, 1977, and 1978 should be adjusted to reflect additional income in the amounts of $487,365.00, $116,095.00 and $11,644.00, respectively.

Issue 8.

Preferential Dividends Received During the Taxable Years of 1976 and 1978

Evidence was presented at trial on this issue, but following the trial the parties settled. Therefore, there should be no adjustments to Ted and Sandra's income for 1976 and 1978 with respect to the issue of preferential dividends related to Ted Olson's various accounts with OBMC. The claim of Ted and Sandra concerning a proposed credit for 1977 has been abandoned.

ISSUE 9.

Preferential Dividend Received During 1980 in Connection with the Stock Buy Out of Olson Bros. Manufacturing, Inc.

The IRS audited Ted and Sandra's 1980 tax return. A proposed adjustment to the gross income of Ted and Sandra was made by the audit in the amount of $373,569.00. The IRS claims that Ted received a constructive dividend from OBMC as a result of a contract entered into between Ted and Carroll Olson for the sale of shares of OBMC stock to Ted.

Ted Olson owned 50 percent of OBMC. Carroll Olson and Mrs. Carol Olson together owned the other 50 percent of the outstanding stock. On January 15, 1980, Ted and Carroll executed a contract entitled Agreement for Sale of Stock, in which Ted agreed to purchase the shares of stock owned by Carroll and Mrs. Carol Olson (Exhibit 151 and 245). The Agreement was signed by Ted and Carroll. Ted was identified as the buyer and Carroll Olson and Mrs. Carol Olson, husband and wife, were identified as the "seller" for the sale of the stock interest owned by seller.

The Agreement provided that the purchase price for the sellers' share was $1,760,000.00, subject to each and all of the conditions and adjustments specified in the Agreement. As part of the sales price, the "seller" agreed to accept as part payment the cancellation of their present indebtedness to OBMC, which was computed on January 15, 1980, to be $163,940.85. In addition, the "seller" agreed to accept as part payment the transfer and delivery of irrigation equipment supplied by the buyer, up to a total value of $200,000.00.

The debt of Carroll Olson and Mrs. Carol Olson to OBMC was canceled, thereby relieving them of $163,940.85 of obligations to OBMC. Carroll Olson and Mrs. Carol Olson also received the ten center pivot irrigation systems valued at $200,000.00.

Carroll Olson and Mrs. Carol Olson reported the $163,940.85 forgiveness of debt and the $200,000.00 worth of irrigation equipment as income on their income tax return.

None of the other requirements of the Agreement were fulfilled. After OBMC filed bankruptcy, a national accounting firm audited the books and found that rather than the company having a positive net worth as was assumed in the Agreement, there had been an error of at least $1 million in overstating the value of OBMC's assets and, shortly after the execution of the Agreement, over $3 million of contracts for irrigation systems were canceled. Therefore, if there had actually been an adjustment of the purchase price pursuant to paragraph II, the price would have been significantly lowered.

The Agreement, at paragraph VIII, required the buyer to execute and deliver to "seller" a promissory note for the balance of the purchase price. In addition, the buyer was to procure from and to have executed by the corporation (OBMC) a second real estate mortgage encumbering certain real estate owned by the corporation and encumbering irrigation equipment installed on such real estate. That real estate mortgage was to be "sanctioned, approved and authorized by the stockholders and directors of the corporation."

Ted Olson testified that Wells Fargo Business Credit, an organization which was financing OBMC, refused to permit the corporation to execute such a mortgage and, therefore, no mortgage was ever provided as security for the note. In fact, no note was ever executed by Ted Olson. Both Ted and Carroll Olson testified to the fact of the nondelivery of the note.

Paragraph XIV required Carroll Olson and Mrs. Carol Olson to resign as directors and officers of the corporation upon execution of the Agreement. Neither Carroll Olson nor Mrs. Carol Olson resigned as an officer or director of the corporation at any time.

Paragraph XV required Carroll Olson and Mrs. Carol Olson to assign, transfer and deliver to Ted all of their stock, concurrent with the execution of the Agreement. Carroll Olson testified that because he did not receive the promissory note or mortgage, he did not arrange for the transfer of stock owned by him and his wife. He also testified that he still has the stock.

There is no evidence that Mrs. Carol Olson had agreed to any of the provisions of the "Agreement." Her signature is not on the Agreement. She did not testify at trial.

This Court finds as a fact that the Agreement was not fully consummated. All parties to the "Agreement" did not execute it. Many of the contingencies which were mandatory did not occur. Ted did not become the owner of 100 percent of the stock of OBMC. The Agreement could not be performed and the nonperformance was not the fault of either Ted or Carroll. The corporation was not allowed by its lender to execute the mortgage which was security for the purchase price.

Finally, Carroll did receive a benefit by virtue of partial performance of the Agreement. He had his indebtedness forgiven and he received ten irrigation units. He and his spouse also paid taxes on the recognized income from the transaction.

Ted received no benefit from the Agreement, because it was not completed.

A taxpayer who is a stock holder has been held to have received constructive dividends in many situations where he has received an economic benefit as a result of the payment made to him or for his benefit by the corporation. Commissioner v. Riss, 374 F.2d 161, 167 (8th Cir. 1967); Sachs v. Commissioner, 277 F.2d 879 (8th Cir. 1960). The Eighth Circuit has set forth one criterion for determining whether a payment constitutes a constructive dividend:

> The motive, or expressed intent of the corporation is not determinative, and constructive dividends have been found contrary to the expressed intent of the corporation. The courts, as arbiters of the true nature of corporate payments, have consistently used as a standard the measure of receipt of economic benefit as the proper occasion for taxation. (footnote omitted)

Sachs v. Commissioner, 277 F.2d 879 at 882-883.

This adjustment by which the IRS claims Ted and Sandra's 1980 gross income should be adjusted in the amount of $373,569.00 as a preferential dividend was not "assessed" and, therefore, does not enjoy the presumption of validity.

The IRS has presented no evidence that Ted received any economic benefit from this transaction. Ted and Sandra have presented significant evidence concerning the failure of consideration with regard to the "Agreement" and the lack of economic benefit received by them. Even if the debtors have the burden of proof, the evidence they have presented convinces this

Court that they received no economic benefit and are not the recipients of a preferential dividend. The IRS has failed to meet its burden of proof.

Therefore, the 1980 adjustment to gross income in the amount of $373,569.00 as proposed by the IRS should be and is hereby denied.

Issue 10.

Commodity Futures Transactions (1976 - 1979 and 1981).

For each of the following taxable years, Ted and Sandra claimed as ordinary losses their net losses in corn and cattle commodities futures transactions in the following amounts:

1976	$124,780.00
1977	$100,966.00
1978	$129,048.00
1979	$591,080.00
1981	$ 15,785.00

These amounts were reported as corn and cattle "hedges" by Ted and Sandra on the Schedule F (Farm Income and Expenses) of each of their joint federal income tax returns for the taxable years listed above.

Following an audit of Ted and Sandra's federal income tax returns, a statutory notice of deficiency dated December 21, 1982, was issued to Ted and Sandra for the 1976, 1977 and 1978 taxable years by the Commissioner of Internal Revenue. Reflected in this statutory notice of deficiency was the Commissioner's determination that the amounts of ordinary losses claimed by Ted and Sandra as corn and cattle "hedges" for 1976, 1977 and 1978 should be disallowed because Ted and Sandra's corn and cattle commodities futures transactions in those years did not represent true "hedging" losses, but rather speculative transactions in those commodities. Therefore, for purposes of this case, the adjustments by the IRS for 1976, 1977 and 1978 were "assessed." As noted above, such "assessment" gives the position of the IRS a presumption of validity.

For the 1979 and 1981 taxable years, similar adjustments were proposed by the examining agent. However, these adjustments were not "assessed" and have no presumption of validity.

Section 165(a) of the Internal Revenue Code of 1954 (26 U.S.C.), as amended, provides that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." This provision, however, is qualified by Section 165(f), which states that "losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in Sections 1211 and 1212."

Section 1221 of the Internal Revenue Code provides, in general, that a "capital asset" is "property held by a taxpayer." The definition thereafter excludes certain types of property such as property of a kind that would normally be included in inventory, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Commodity futures contracts are not specifically listed as an exclusion to the definition of a capital asset and such contracts do not fit within any of the specific exceptions. Therefore, gain or loss from trading such contracts is normally a capital gain or loss. Hendrich v. Commissioner, 40 T.C.M. (CCH) 997, 999 (1980); Estate of Laughlin v. Commissioner, 30 T.C.M. (CCH) 227, 230 (1971). The courts have recognized that commodity futures contracts are not capital assets when they are used to provide bona fide hedging protection in the taxpayer's business. Commissioner v. Farmers & Ginners Cotton Oil Co., 120 F.2d 772, 774 (5th Cir. 1941), cert. den'd., 314 U.S. 363 (1941).

In Muldrow v. Commissioner, 38 T.C. 907, 913 (1962), the Tax Court defined the term "hedging" as follows:

> A hedge. . .is not a transaction looking to a favorable fluctuation in price for the realization of profit on the particular futures contract itself, as in the case of a speculative or capital transaction, but is a form of insurance against unfavorable fluctuations in the price of commodity in which a position has already become fixed or, as in the case of a producer such as a cotton grower, will become fixed in the normal course and the sale, liquidation or use of the commodity is to occur at some time in the future.

The essence of hedging is a balanced position. United States v. Rogers, 286 F.2d 277, 281 (6th Cir. 1961), cert. den'd. 366 U.S. 951 (1961); Commissioner v. Farmers & Ginners Cotton Oil Co., supra, at 774. Thus, where a hedge is made, a position is taken in the futures market to offset a risk with respect to actual. Meade v. Commissioner, 32 T.C.M. (CCH) 200, 209 (1973). For example, a farmer who expects to harvest a corn crop of 5,000 bushels six months in the future can obtain protection against a decline in prices by selling futures contracts, or going "short," for 5,000 bushels of corn. Patterson v. Commissioner, 41 T.C.M. (CCH) 807 at 809 (1981). Since the price on the futures market generally follows the price trend for the actual commodity, any loss resulting from a decline in the price with respect to the farmer's own corn is counterbalanced by a profit realized from closing out or covering the short sale (either by actual delivery of the commodity or purchasing an offsetting contract at a commensurably lower price.) In such a situation, the farmer is not seeking to profit through speculation, but rather is interested in minimizing the risks of adverse price fluctuation in the corn in which he has a fixed position. See Muldrow v. Commissioner, supra; Patterson v. Commissioner, supra, Meade v. Commissioner, supra. Similarly, a manufacturer who will need raw materials at a future time can protect itself against a rise in prices by purchasing futures contracts, or going "long," for a quantity of materials which it expects to need in the future. See United States v. Rogers, supra, at 281.

In another situation in which a true hedge or balance was not accomplished, the Supreme Court in Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 76 S. Ct. 20 (1955) recognized that in order to give rise to ordinary income (or loss) treatment, the commodity futures contract transactions must be integrally related to the taxpayer's business. There, the taxpayer, a processor of corn products, purchased corn futures to ensure an adequate supply of raw corn and to protect itself against a sharp increase in corn prices. Although the future contracts did not provide the taxpayer with complete protection from its market operation, the court held that taxpayer's profits from the sale of such contracts (effected as it became apparent that not all of the corn covered by the contracts would be needed) were taxable as ordinary income because Congress did not intend such transactions that were "an integral part" of the taxpayer's business to be taxed under the capital asset provisions. Id. at 350 U.S. at 50-52.

The Supreme Court has recently explained the logic, analysis and conclusion in the Corn Products case in Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 108 S. Ct. 971 (1988). In that case, a bank holding company had attempted to deduct as an ordinary loss its losses on the sale of corporate stock it owned in a bank. The Court of Appeals for the Eighth Circuit had reversed a Tax Court determination that certain of the losses attributed to the sale of the stock could be deducted as ordinary income because the stock had been acquired for a business purpose or a business investment purpose. Arkansas Best Corp. & Subsidiaries v. Commissioner, 800 F.2d 215 (8th Cir. 1986).

At the Supreme Court, the taxpayer argued that the acquisition of the bank stock was in the ordinary course of business and an integral part of its business. Relying upon Corn Products Refining Co. v. Commissioner, supra, the taxpayer urged the Supreme Court to permit the treatment of the loss on the sale of such stock as an ordinary loss. In rejecting the taxpayer's argument, the Supreme Court interpreted the Corn Products decision as involving only an application of Section 1221's inventory exception. It went on to state:

> . . .[T]hat although the corn futures were not "actual inventory," their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of "property of a kind which would properly be included in the inventory of the taxpayer" in section 1221.
>
> Petitioner argues that by focusing attention on whether the asset was acquired and sold as an integral part of the taxpayer's everyday business operations, the Court in Corn Products intended to create a general exemption from capital-asset status for assets acquired for business purposes. We believe Petitioner misunderstands the relevance of the Court's inquiry. A business connection, although irrelevant to the initial determination whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer's business in Corn Products was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory-purchase system, and instead amounted simply to speculation in corn futures, they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion. We conclude that Corn Products is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of section 1221.

Id. 485 U.S. at 221-222 (emphasis added). See also Barnes Group, Inc., v. United States, 697 F.Supp. 591 at 596-597 (D. Conn. 1988).

From an analysis of the Corn Products decision as explained by the Arkansas Best decision, it appears that the inquiry concerning the tax treatment of losses incurred in commodity futures transactions should focus upon whether or not such transactions and such contracts were "surrogates for the stored inventory of raw corn" or similar inventory items, such as cattle on feed. Such inquiry will lead to a factual determination based upon the evidence presented by the parties.

For those years in which the adjustments proposed by the IRS were "assessed" it is the initial burden of the debtor to present evidence overcoming the presumption of validity which attaches to the assessment if the assessment is reasonably based upon facts.

The IRS presented testimony of an IRS employee who specialized in commodity futures transaction analysis for the Service. He analyzed information provided by the accounting firm for Ted and Sandra and did his own analysis. He determined that most of the corn trades were short-term trades opened up and closed out within a ten-day period. In addition, there were many day trades. He testified that it is the position of the IRS, based upon case law, that short-term trading patterns are indications of speculation because, with respect to a producer, if a short position is entered into and closed out within a brief period of time and the producer is still holding the actual position in the crop, the producer is subject to risk. A taxpayer who opens up a position to hedge against the risk that the price of the actual crop will decline and then closes it out, waits a few days, opens it up, closes it out, opens it up, closes it out, and so on, as Ted and Sandra appeared to have done, is more likely than not to have been engaging in speculative activity. He further testified that for a farmer or a producer to be in a long position in futures (contracts to purchase corn) while maintaining a long position in the actual cash crop (actually have crop on hand or in fields), as Ted and Sandra were, would be incompatible with hedging. To hedge, a producer generally would go short in futures (contract to sell) to hedge an existing long position (actual possession) in a cash crop. According to the witness, this conclusion is logical because if only long positions were held and the market price of the particular commodity fell, Ted and Sandra stood to lose on both their commodities and their futures contracts themselves. Therefore, rather than serving the protective function of reducing the risks, Ted and Sandra's long positions doubled such risks.

Finally, with regard to corn futures, the witness determined that Ted and Sandra were "straddling" or "spreading" in the corn futures market. That is, they were simultaneously long and short in different contract months in the corn commodity futures market. It is the position of the IRS that when a taxpayer is straddling, that taxpayer is probably not engaged in legitimate hedge transactions and is more likely speculating. The holding of a spread position, that is, simultaneously long and short positions in two different delivery months of the same commodity is speculative since its normal purpose is to profit from changes in market price.

The position taken by the witness on behalf of the IRS is supported by case law. Day v. United States, 734 F.2d 375 (8th Cir. 1984); Patterson v. Commissioner, supra; Hendrich v.

Commissioner, supra; Carpenter v. Commissioner, 25 T.C.M. (CCH) 965, 968 (1966); Battelle v. Commissioner, 47 B.T.A. 117, 126 (1942); Sicanoff Vegetable Oil Corp. v. Commissioner, 27 T.C. 1056, 1070 (1957), rev'd. on other grounds, 251 F.2d 764 (7th Cir. 1958).

With regard to cattle futures contracts, the witness noted that most of the contracts were held less than ten days. Since the fattening period on average cattle is between 120 and 150 days, it appeared to the witness that the commodities transactions were speculative and not entered into to offset potential loss on the actual animal sales. The position of the IRS has case support. Oringderff v. Commissioner, 38 T.C.M. (CCH) 402 (1979), aff'd., 48 A.F.T.R. 2d 5908 (10th Cir. 1981).

Based upon the testimony of the witness for the IRS, the Court concludes that the IRS met its initial burden of showing a reasonable basis for its assessment.

Ted and Sandra presented no evidence to support their position that the commodity future contract transactions were true hedges. It is clear from the analysis prepared and testified to by the IRS witness and the listing of the trades as offered by the debtors, Exhibits 281 and 277, that no particular trade was entered into to offset a potential decline in price of the actual commodity. No contract was held for a long enough period of time to provide any type of offsetting relationship ensuring against risk of a decline in the price in the actual commodity. Ted Olson testified concerning the purpose of the transactions, but he did not identify any one or group of transactions which would put the actual or cash commodity either growing or on hand in balance with the short or long positions taken by the taxpayer on any particular date or series of dates.

The expert witness for Ted and Sandra stated that one could not determine the taxpayers' intent by simple reference to an "analysis" of the trade sheets. He testified that the trading activity as evidenced by the trade sheets was reasonable, consistent with their trade and business and involved commodities which they dealt with in their farming and cattle operations. His position was that these considerations could only lead to a conclusion that the transactions were true hedge trades.

The Court concludes as a fact that there is insufficient evidence presented by Ted and Sandra to convince the Court that in any year, whether covered by an "assessment" or not, there was a true hedge.

Therefore, the factual inquiry must turn to the issue of whether the future contracts were "surrogates for the stored inventory of raw corn" or surrogates for an inventory of cattle.

From 1976 through 1981, Ted and Sandra were producers of corn, buyers of corn, sellers of corn and feeders of corn. They farmed more than 4,000 acres which were planted mainly to corn. They had corn storage available for approximately 800,000 bushels. From 1977 through 1981 they fed 4,000 to 5,000 head of cattle. In each year, they raised more than 600,000 bushels of corn.

Ted Olson explained that he entered the futures market because of fluctuation in the corn market. In 1973 the price of corn was from $1.00 to $1.30 per bushel. The Government announced a "Russian grain deal" and the price went to $2.10 per bushel. In order to protect his interest in the corn that he was buying or growing, he decided to hedge. He made decisions with the advice of a broker and he subscribed to a newsletter entitled "Pro Farmer." He was very familiar with the tax aspects of hedging. He acknowledged that he knew that a loss on a true hedge would be treated as ordinary loss and that a loss on speculation would be treated as a capital loss.

In addition to being in the commodity futures market for corn and cattle, commodities which were directly related to his business, he was also in other commodities futures contracts. For example, Ted invested in what he knew were speculative accounts and not related to his business. He was involved in silver, gold, pork bellies, treasury bills and soybeans on the commodities market. Gains and losses on those transactions were treated as capital gains or losses.

He testified that he was in the commodities futures contracts in 1976 in corn "to improve the profit position on the farm." Although he produced corn, he also purchased on the cash market and sold both on the cash and futures market. His overall purpose was to balance actual supplies available in the bin and in the field with his actual needs. He needed 4,000 bushels per day during the feedlot season to feed cattle from 1977 through 1981. He had a grain buyer's license and he used it to purchase corn for the feedlot. He purchased actual corn and sold actual corn and he fed corn to livestock. The exhibits substantiate his testimony that during those years he did, in addition to raising corn and engaging in futures transactions, buy and sell corn.

Although he had extensive storage capacity for corn, he testified that he also had commodity loans on stored grain and, therefore, in many years he kept his storage full even when he was at harvest time. In other words, he had grain in the field and grain in the bin and grain being harvested at the same time.

Concerning the corn transactions, the testimony and documentary evidence presented by Ted is not sufficient to overcome the presumption that the "assessment" is correct. Although Ted testified in detail about his businesses from 1976 through 1981, he did not provide any information as to how day trades and transactions opened and closed within very short time spans actually provided assets which were "surrogates for the inventory of raw corn." Acknowledging that he had corn on hand, corn in the field, and that he bought and sold corn as well as fed corn on a regular basis, this Court cannot determine from the evidence presented what connection there was between those activities and the day-in and day-out purchase and sale of commodities contracts.

Under the case law referred to above, it is not sufficient for the contracts to be in commodities that are the same as those commodities in which the taxpayer is involved in as a trade or business. There must be some "integral" relationship between the transactions themselves and the business. In the Corn Products case, the taxpayer had a need to guarantee a supply of corn at a particular time. When the taxpayer realized that it had a sufficient supply of corn to cover its processing needs, the taxpayer sold the contracts it had purchased to assure the supply. The transactions were entered into and were ultimately closed out as a logical part of the taxpayer's business.

In the case of Ted and Sandra Olson, the transactions were entered into and closed out sometimes on the same day. Most of the contracts were opened and closed within ten days and very few were held longer than thirty days. The connection between the business needs of the taxpayer and the commodity transactions is lacking.

However, the analysis of the cattle commodities transactions leads to a different result. The IRS expert witness testified that Ted was a producer in cattle because he acquired, fed and fattened to a saleable weight and then sold the cattle. The witness claimed that the short-term trades and holding patterns in 1978 and 1979 are inconsistent with hedging. He said that the fattening period is 120 to 150 days for cattle and that the holding periods for the contracts were, on average, less than ten days. He suggested that taking a long position in the cattle futures market would in general be incompatible with a hedge unless the producer was doing so to guarantee replacement of inventory. He acknowledged that he did not consider in his analysis either Exhibit 271 or 272 which are the records of cattle purchases and cattle sales in the appropriate year. He, therefore, was unable to answer or give an opinion on whether the cattle purchases and sale were significant with regard to the issue of whether or not the commodity futures transactions should be treated as hedges under the Corn Products analysis.

He was not familiar with Ted's actual cattle operation during the years in question and based his opinion that the commodities futures transactions could not result in ordinary losses solely upon his analysis of the holding periods for the contracts. He did acknowledge that if prices of the actual commodity fluctuated or costs of the producer fluctuated, it would be appropriate for a producer to close out a contract early and still have a hedge and, therefore, deduct the loss as an ordinary loss. It was further his opinion that if the motivation in the transaction was to lock in a price and manage risk that the transaction is then integrally related to the business. He further acknowledged that none of the cases which are relied upon by the IRS consider the volatility of the market and he acknowledged that volatility would give an incentive to hedge.

Ted Olson testified that in the cattle market one could purchase cattle in the spring relatively cheaply. In the fall the cattle were more expensive. He could buy cattle through futures contracts in the spring, that is, go "long" and purchase the actual animals in the fall. He paid a higher price for the animals in the fall than he would have in the spring, but was able to offset and thereby "balance" his position because of the lower priced contracts which he had purchased in the spring.

He was a feeder. The cattle he purchased in the fall were to be sold in spring and summer. There appears to be a logical connection between this testimony and the exhibits representing his purchase and sale of cattle, Exhibits 271 and 272. The exhibit reflecting his long and short position in cattle futures, Exhibit 281, is also consistent with this testimony.

Ted was being financed in the cattle operations by the Production Credit Association. In at least one year, the PCA recommended that he hedge his cattle. He took a short position, that is, he contracted on the futures market to sell cattle at 67 cents per pound, or $67.00 per hundred weight (cwt.). The market was volatile and went the other way. The PCA advised him to get out of the contracts because it was their opinion that the price would go to 90 cents. Upon the advice of the PCA, he closed his contracts at 77 cents and, therefore, lost 10 cents per pound or $10.00/cwt.

The examples given above were the testimony of Ted Olson concerning the reason for being in the cattle futures contracts. He had cattle on feed. He purchased, fed, and eventually sold cattle during the year. He needed an assurance that he would be able to replace his cattle inventory at a particular time and that was his motivation for entering into futures contracts. Thus, he entered into the cattle commodities futures contracts as a "surrogate" for inventory of live cattle. He had a legitimate business reason for opening and closing futures contracts with regard to cattle and he had a legitimate inventory control need which was apparently met by being in the futures market.

In conclusion, Ted and Sandra have failed to present sufficient evidence concerning their right to an ordinary loss deduction for corn futures from corn futures transactions covered by the assessment in years '76, '77 and '78. The assessment is presumed to be valid and such presumption has not been overcome. With regard to the corn futures transactions which are not the subject of an assessment, the IRS has shown by an analysis of the transaction that there does not appear to be a relationship between the opening and closing of corn futures contract on a day-to-day and short-term basis and the inventory needs of the business. Ted and Sandra have presented no evidence connecting the transactions to the inventory needs of the business. Therefore, the Court concludes that Ted and Sandra have no right to the ordinary loss deductions claimed for corn transactions. Their tax returns for the years in question must be adjusted to reflect this factual conclusion.

Ted and Sandra have presented sufficient evidence to overcome the presumption of validity of the assessment with regard to cattle futures transactions. The IRS presented no evidence to rebut the "inventory connection" evidence presented by Ted and Sandra. Therefore, for all of the tax years in question, the taxpayers, Ted and Sandra Olson, are allowed to take an ordinary loss deduction for their losses in the cattle futures transactions. The adjustment proposed by the IRS is denied.

Issue 11.

Investment Interest (1979 & 1981)

Following an IRS audit of Ted and Sandra's tax returns for the taxable years of 1979, 1980 and 1981, the IRS proposed to disallow the interest expense deductions claimed by Ted and Sandra for the 1979 and 1981 taxable years to the extent of $300,000.00 and $450,000.00, respectively, under the investment interest limitations of Section 163(d) of the Internal Revenue Code.

On the Schedule F (Farm Income and Expenses) of their federal income tax return for the year 1979, Ted and Sandra claimed a deduction for interest in the amount of $502,081.00. Of that amount, the IRS, following an audit of Ted and Sandra's tax return, proposed to disallow $300,000.00. On the Schedule F of their federal income tax return for the year 1981, the plaintiffs claimed a deduction for interest in the amount of $709,396.00. Of that amount, the IRS, following an audit of Ted and Sandra's tax return, proposed to disallow $450,000.00. These adjustments are not based upon an "assessment." Therefore, there is no presumption of the validity of the adjustments.

Under the provisions of Section 163(d), deductions claimed by taxpayers in connection with the investment of borrowed funds were limited to $10,000.00, plus the net amount of any investment income. 26 U.S.C. § 163(d)(1). The IRS examiner who made the initial determination with regard to these adjustments did not testify at trial. The audit report was admitted into evidence at Exhibit 109. At page 20 of the audit report there is an explanation of the adjustment. The justification for the adjustment is contained on page 20 and is quoted completely below:

> Taxpayers have investments of over $2.5 million in losses on commodities prior to 1979, and another one-half million in 1979, which total over $3 million in short-term capital losses.
>
> Most or all of this was borrowed and lost through several brokerage firms. It was determined that a large percentage of interest expense would be investment interest used to pay John Hancock, Prudential and P.C.A. of O'Neill for capital advanced and used in the commodity market. Taxpayers have not generated this type of capital from any of their operations - the only source would be borrowed funds. Since taxpayers failed to make any allocations along these lines, it has been determined that a certain amount of the interest claimed each year would be investment interest.
>
> The deduction by non-corporate taxpayers for interest on investment indebtedness is limited to $10,000 per year, plus the taxpayers' net investment income. Interest deductions disallowed under this rule are entitled to an unlimited carryover and may be deducted in future years, subject to the annual limit.

	1979	1981
Debt on Commodities	2,500,000.	3,000,000.
Rate of Interest (est.)	12%	15%
Total Interest	300,000.	450,000.
Less: Limitation	(10,000.)	(10,000.)
Adjustment to Income	290,000.	440,000.

From the above it can be concluded that the position of the IRS is that the debtors lost a lot of money in the commodities markets from 1973 through 1981. In addition, during some of those years, the debtors borrowed money from various sources. According to the IRS, then, since the debtors did not generate income sufficient to cover the commodities losses over the years, some of the money used to pay the commodities losses must have come from loans. Since the debtors paid interest on those loans, it follows, according to the logic of the IRS agent, that some of the interest paid should be treated as investment interest as defined under Section 163(d) of the Tax Code. From that conclusion, the agent made a guess as to the amount of total interest that should be allocated as investment interest. First, he added up all of the commodity losses that the debtors had between 1973 and 1979 and concluded that those losses equaled $2,500,000.00. He then picked an interest rate from some place and decided that the appropriate rate was 12 percent. He multiplied 12 percent by $2,500,000.00, which is $300,000.00. He then concluded that there should be an adjustment to income of $300,000.00 for 1979.

For 1981, he did a similar calculation. He added up all of the commodity losses from 1973 through 1981 which totaled $3 million. He then chose another interest rate, this time 15 percent, and calculated a total interest of $450,000.00. He made an adjustment to income of $450,000.00.

At trial the IRS presented very little evidence in support of this position. The witness for the IRS, who was not the examiner, testified that the debtors must have borrowed money to pay their commodities losses and if they did so they paid investment interest. According to the witness, the calculations by the examiner, although somewhat arbitrary, were based upon a reasonable theory.

The IRS presented no legal authority for its position. The statute at 26 U.S.C. § 163(d)(3) defines investment interest as "any interest allowable as a deduction under this chapter which is paid or accrued <u>on indebtedness incurred or continued to purchase or carry property held for investment</u>." (emphasis added)

The IRS presented no evidence that commodity <u>losses</u> are "property held for investment." The IRS presented no evidence that any specific loans obtained by Ted and Sandra were used to pay commodity losses. Concededly, there are page after page of documents representing loan agreements entered into by Ted and Sandra between 1976 and 1981. Monies were obtained for farm operations and for purchase of land. There is no evidence that any loan was incurred in 1979 or in any other year to pay $2,500,000.00 in commodity losses, even assuming that a "commodity loss" is property held for investment. The same is true for 1981.

The tax returns show that Ted and Sandra Olson had cash available to them over the five-year period from 1976 to 1981 in the millions. They sold corn and cattle. Ted had a salary of between $150,000.00 and $200,000.00 per year from OBMC. The documents in evidence concerning the loans show the source and use of the funds obtained from the loans. For several of the loans, a certain amount of cash was delivered directly to Ted or Sandra after the main purpose of the loan was satisfied. In no case did the net amount received from the loans by Ted and Sandra which was then available for their own use equal $2,500,000.00 or $3 million. Exhibit 288 shows a disbursement to Ted in the amount of $119,350.00 at check #249. At check #165 there is a distribution to Ted Olson in the amount of $148,500.00. At check #393 there is a distribution of $1,209.63. At Exhibit 290 there is a distribution in the amount of $321,208.39. At Exhibit 291 there is a distribution of $88,600.00.

The examples listed above are from loans incurred in 1976 and 1978. The total commodity losses in 1976 were $124,780.00. In 1977 they were $100,966.00. In 1978 they were $129,048.00. In 1979 they were $591,080.00. In 1981 they were $15,785.00. There appears to be no connection between the amount of the losses and the loans incurred by Ted and Sandra from 1976 through 1981.

Reviewing Exhibit 109 further, one finds that on page 21 the examiner came up with this total of $2,500,000.00 in commodity losses as of 1979 by adding losses from 1973 through 1978. There is no evidence that would link loans obtained in 1976 and 1978 with payment of commodity losses in 1973, 1974 or 1975. Ted Olson testified that he didn't borrow any money to pay commodity losses. He had funds available in each year either from operations or from his salary to pay his commodity losses. He explained that he obtained the commodity contracts on margin. In other words, he put up a small percentage of the total contract when purchased or sold. When the contract was closed a calculation was made to determine whether there was a gain or a loss. If there was a loss he was required to make a payment to the broker. He did so on a monthly basis from funds on hand.

Mr. Warren Hinze, a CPA who testified as an expert witness for Ted and Sandra, has been a tax accountant for forty years. He had never heard of the IRS theory as it relates to commodity losses. He testified that the Code provisions dealing with limitations on investment interest had no application in this case. It was his understanding of the law, from his long years of tax practice, that the Internal Revenue Code provisions that deal with "investment interest" are limited to circumstances in which interest expense is incurred to "hold an investment." This limitation keeps a taxpayer from deducting the interest on a loan used to hold an appreciating asset which was not paying any income. The deduction was limited to $10,000.00 plus any income received from the investment.

Without this limitation, the interest deduction was a form of tax shelter, until the investment was disposed of. However, once the investment was disposed of, there would be no interest necessary to "hold the investment," and the need to limit the "shelter" would disappear. Any interest that remained on loans to cover "losses" on the investment, remain deductible at that point.

He testified that this concept had absolutely nothing to do with commodities trades involving the Olsons. First of all, there was no borrowing necessary to "hold" a commodity investment. Commodities were purchased on margin. If the margin were extended on the broker's credit, there may have been a small amount of interest accumulated on the account. However, in Ted and Sandra's case, even assuming such interest existed, it would not have exceeded the $10,000.00 limit. All of the commodities contracts were eventually closed and losses or gains taken. At no time did Olson need to borrow money to incur interest or incur interest to "hold" these investments. The Olsons only had to deal with any actual loss or gain on the transaction.

Even the IRS witness who testified in support of the IRS position agreed that the use of "investment interest" limitations in this case was inconsistent with the reason for the rule.

Mr. Hinze, the expert witness for Ted and Sandra, testified that after he analyzed the cash position of the Olsons for the various years, he concluded that the Olsons had adequate cash from a number of sources to cover any commodity losses.

In conclusion, the Court finds that there is no factual or legal basis for the proposed adjustments and they are denied.

Issue 12.

Employee Business Expense Deduction 1981.

The IRS auditor proposed to disallow the employee business expense deduction claimed by Ted and Sandra in the amount of $574,516.80 on Form 2106 (Employee Business Expenses) attached to their 1981 tax return. There is no dispute between the parties that Ted Olson advanced a total of $574,516.80 to OBMC during 1980 and 1981. OBMC used the funds for supplies, wages and other expenses of operation. The IRS determined that this amount does not qualify as an employee business expense deduction because the nature of the expenditure does not fall within any of the requirements of Section 62 of the Internal Code. That section permits a taxpayer to deduct from gross income entertainment, transportation, office and other customary business expenses which met the "ordinary and necessary" test. Those deductions are limited to:

1. expenses of travel, meals and lodging while away from home in the performance of services as an employee;

2. other expenses to the extent covered by reimbursement or other expense allowance arrangement by the employer;

3. business transportation expenses, other than the cost of commuting to and from work;

4. outside sales person expenses attributable to soliciting business for the employer, away from the employer's place of business; and

5. employee's and self-employed person's moving expenses.

To be deductible, employee business expenses must be "ordinary and necessary" to carrying out the employment duties of the employee. An expense is "ordinary" if it can be expected to arise with some degree of constancy in the particular business, and need not be habitual or normal in the sense that the taxpayer would have to make them often. Furthermore, such an expense is "necessary" if it is "appropriate and helpful" to the development or conduct of a trade or business.

At all times pertinent to this case, Ted was a shareholder in OBMC. Shareholders, unless they are traders, do not engage in a trade or business when they invest in the stock of a corporation. Whipple v. Commissioner, 373 U.S. 193, 202, 83 S. Ct. 1168 (1963). Consequently, shareholders are generally not permitted to deduct under Section 162(a) sums advanced to a corporation to meet its expenses or pay its debts. Such expenditures, if not loans, are generally considered capital contributions. 26 U.S.C. § 263, Treas. Reg. 1.263(a)-2(f) (voluntary contributions by shareholders for any corporate purpose are nondeductible capital expenditures). In Betson v. Commissioner, 802 F.2d 365 (9th Cir. 1986) the court denied the taxpayer's deduction under Section 162 because it found that the taxpayer's dominant motive in paying the expenses was to provide operating capital and perpetuate or revitalize the corporation.

In determining whether payments made on behalf of a corporation are capital contributions a dominant factor is the motive or purpose of the transferor in making the payments. Washington Athletic Club v. United States, 614 F.2d 670, (9th Cir. 1980). Sums advanced with the intent of yielding income in future years are generally considered capital expenditures. Encyclopedia Britannica, Inc., v. Commissioner, 685 F.2d 212, 214 (7th Cir. 1982). To deduct expenses on Form 2106, the expenses would have to occur in the year for which a deduction is sought.

As mentioned above, the parties do not dispute that Ted Olson actually made the advances to OBMC. The issue is whether he properly classified the item on his 1981 tax return. At trial, Ted and his accountant basically conceded that the advances did not fit into the statutory requirement of 26 U.S.C. § 162 with regard to employee expense deductions. However, they took the position that the amounts were deductible in 1981 as a bad debt deduction (26 U.S.C. § 165(c)). To support that position, Ted testified that he was president of OBMC and earned a salary of $150,000.00 to $200,000.00 per year. He had made a minimal investment in OBMC of $25,000.00 back in the late 60's or early 70's for purchase of stock in the company. He had been receiving a salary as president of the company for many years and the company had been highly successful in the industry of manufacturing center pivot irrigation units.

In 1980, the company ran into financial difficulty. The Russian grain embargo imposed by the president of the United States caused a cancellation of a significant portion of the contracts which had been entered into by the company for the production year 1980. At that time, the company was obtaining financing from Wells Fargo Business Credit. That entity based its financing upon a formula which included accounts receivable. If the company was unable to stay within the formula, it could not obtain financing to complete the manufacture of units which were on order, but not delivered.

In 1980, Ted advanced funds to the company on occasions when the company had no other financing to complete its orders and pay its payroll and suppliers. By the end of 1980, the financial position of the company and its relationship with its lender was in such serious deterioration that the company filed for Chapter 11 bankruptcy protection. Thereafter, the company ran into a major blockade by its secured creditors with regard to the use of cash collateral. Much litigation ensued in the bankruptcy court and Ted advanced funds during the litigation to keep the company operating. Eventually the bankruptcy judge removed management, including Ted, and appointed an operating trustee. Within a few months thereafter, the company's Chapter 11 bankruptcy case was converted to a liquidation case under Chapter 7 of the Bankruptcy Code. That conversion was in early 1982.

There is evidence in this record that the liquidation provided no funds to any unsecured creditor. During the bankruptcy case, Ted had attempted to obtain permission of the bankruptcy court to loan money to the corporation either on a secured basis or as an administrative claim with some type of priority. Even though he continued to provide money to OBMC while in bankruptcy on an unsecured basis, he was never able to get authorization from the bankruptcy court for secured status or any type of priority.

There is no evidence which would permit this Court to conclude that the contributions by Ted to the continued operation of his business in 1980 and 1981 were capital contributions. There is no reason why Ted would make a capital investment in a corporation that has the type and degree of deteriorating financial condition that OBMC had. Specifically, to invest in a business in bankruptcy would serve no purpose under the circumstances in this case. Therefore, this Court finds as a fact that the advances, as testified to by Ted and his accountant, were loans. He went through the effort, once the bankruptcy case was filed, to get court approval for the loans. He did not succeed, but such failure does not convert the advances which were intended as loans into capital contributions.

Whether Ted properly deducted the advances as an employee business expense or as a bad debt deduction makes no difference with regard to the ultimate deductibility issue. The debt was worthless in 1981. OBMC was in bankruptcy, was in a deteriorating financial condition, was unable to pay its unsecured creditors and was liquidated shortly after the end of the year 1981.

In response to the testimony by Mr. Hinze with regard to the business bad debt deduction theory, the IRS alleges that Ted and Sandra are farmers by profession and are not in the business of lending money and thus they cannot claim a "business" bad debt deduction. However, the evidence is that the debtors were farmers; grain producers; cattle producers; grain dealers; investors in the operations in Texas; investors in OBMC; that Ted was the president and chief operating officer of OBMC and had a significant interest in assuring the continued operation of OBMC. His advances to OBMC were partly for the purpose of assuring his $150,000.00 to $200,000.00 salary. In addition, he testified that OBMC was able to purchase farm supplies, including fertilizer, at wholesale because of its corporate reputation. He was able to take advantage of the bulk wholesale purchases made by OBMC which benefitted his farming operation. Ted also owned a trucking operation. The trucking operation hauled for OBMC as well as for the farm operations.

In other words, his loans to OBMC were in furtherance of his trade or business, which, from the evidence presented, could be defined as "an entrepreneur."

On the last substantive page of the second post-trial brief submitted by the IRS, the IRS argues that even if the advances should be treated as a business bad debt deduction, the deduction should be zero because of certain calculations which would have had to have been made on the tax return. Such discussion attempts to present evidence that was not offered at trial. Even though Ted and Sandra presented evidence concerning the business bad debt deduction theory at trial, the IRS did not present any evidence which would indicate that such a deduction, if valid, would amount to zero once the calculations were actually performed on the tax return. Therefore, the attempt by the IRS to offer evidence at this late date in support of the IRS adjustment is not allowed.

In conclusion,the adjustment proposed by the IRS to the 1981 tax return with regard to the deduction of $574,516.80 is denied.

Summary

1. The tax returns of Ted and Sandra for 1977 and 1978 should be adjusted to reflect additional income of $384,500.00 and $226,409.00 respectively due to the disallowance of certain of the "machine hire" expenses claimed by Ted and Sandra on Schedule F for those years.

2. The Olsons are entitled to the deduction for rent expense in 1976 as set forth on their 1976 Form 1040 individual income tax return and no adjustment is required.

3. The Olsons are entitled to the deduction for fertilizer expenses in 1977 as set forth on their 1977 Form 1040 individual income tax return.

4. The parties agree that the taxpayers are entitled to an adjustment to reduce their taxable income in 1976 by $33,441.81.

5. The parties agree that Ted and Sandra are entitled to an adjustment to reduce taxable income for the year 1976 by $2,000.00.

6. The 1978 tax return of Ted and Sandra is not required to be adjusted to reflect an increase of $100,000.00 in income.

7. The federal income tax return of Ted and Sandra for the taxable years of 1976, 1977, and 1978 should be adjusted to reflect additional income in the amounts of $487,365.00, $116,095.00 and $11,644.00, respectively.

8. There should be no adjustments to Ted and Sandra's income for 1976 and 1978 with respect to the issue of preferential dividends related to Ted Olson's various accounts with OBMC. The claim of Ted and Sandra concerning a proposed credit for 1977 has been abandoned.

9. The 1980 adjustment to gross income in the amount of $373,569.00 as proposed by the IRS should be and is hereby denied.

10. For all of the tax years in question, the taxpayers, Ted and Sandra Olson, are allowed to take an ordinary loss deduction for their losses in the cattle futures transactions. The adjustment proposed by the IRS concerning losses on cattle futures contracts is denied. The adjustment proposed by the IRS concerning losses on corn futures contracts is sustained and the tax returns must be adjusted to so reflect.

11. The Court finds that there is no factual or legal basis for the proposed adjustments and they are denied.

12. The adjustment proposed by the IRS with regard to advances in the amount of $574,516.80 to OBMC is denied.

DATED: February 13, 1992.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge