Nebraska Law Review

Volume 54 | Issue 1 Article 5

1975

Tax Primer for Practitioners: Senate Report 93-768

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Commentary

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Tax Primer for Practitioners: Senate Report 93-768†

Few practicing attorneys have the time or inclination to read a new book on federal income taxation. Such books are often specialized and seldom focus on the mundane tax matters which constitute the basic tax practice of the typical attorney. A technical discussion of specialized topics often serves only as a vivid reminder of long law school hours spent wrestling with the complex and unmanageable Internal Revenue Code and Treasury Regulations and adds little to the practitioner's understanding of basic federal income taxing concepts. The Staff Report of the Joint Committee on Internal Revenue Taxation,[1] on its examination of former President Nixon's

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† The report may be obtained from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402 for $6.50.

1. STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, EXAMINATION OF PRESIDENT NIXON'S TAX RETURNS FOR 1969 THROUGH 1972, S. REP. No. 93-768, 93d Cong., 2d Sess. (1974) [hereinafter cited as STAFF REPORT].

The staff normally does not examine or report on individual tax cases. The enforcement of the Internal Revenue Code is the responsibility of the executive branch and the resolution of factual and legal disputes is left to the judiciary. The examination of the President's tax returns was made as a result of his special request to the Joint Committee. The President's request, however, differed materially from the action taken by the joint committee. The President had requested that the committee examine two transactions—the gift of his pre-Presidential papers in 1969 and the sale of 23 acres of land in San Clemente, California in 1970—and that he be informed whether the items were correctly reported on his federal income tax return. The committee expanded its examination to include all tax items for the years 1969 through 1972 and submitted its report to Congress.

It should be noted that the joint committee, in its letter of transmittal, stressed that it had not examined the entire staff report and that it was releasing the report without expressing its own views. Thus, the report is that of the staff only, and although a staff or even a committee report on existing tax issues should not be accorded binding precedental value, its impact on tax practitioners, the revenue service, and even the judiciary could be significant. This is particularly true in this instance because of the stature of the joint committee's staff. The staff has continuously attracted exceptionally well

tax returns for the years 1969 through 1972, is a uniquely stimulating publication on federal income taxation. In addition to providing a lurid exposé of the former President's personal financial affairs, it is a supremely serious and thorough essay on several frequently recurring tax problems and an excellent refresher course for the practitioner in several basic tax concepts.

The staff's analysis is contained in the first 210 pages of the report and is supplemented by 780 pages of exhibits. The exhibits range from the President's complete tax returns for 1969 through 1972 to notes and correspondence regarding repairs and improvements at San Clemente which involve such weighty affairs of state as a fireplace which would not draw properly under certain wind conditions[2] and a bright light and squeaky pantry door which destroyed the candlelight atmosphere during a dinner party for the Hopes, Fords and Arnold Palmer.[3] More substantial are the legal briefs prepared for the Committee regarding the charitable contributions of Mr. Nixon's pre-Presidential papers.[4]

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qualified personnel and is highly regarded by tax practitioners. Also, it has remained relatively free from the usual political pressures associated with congressional committees. This attribute is important because the committee's undertaking required a thorough and impartial examination of issues fraught with political overtones, and because the committee's unique role as investigator, prosecutor and judge made it particularly susceptible to political attack. These concerns are manifested in the report's mechanical and repetitive approach to the issues. The commendable result, however, is an exceptionally cautious and delicate handling of the taxpayer.

2. *See* STAFF REPORT, EXHIBITS VII-1 through VII-7 at A-562-69. This particular transaction commences in January, 1971, with Herbert Kalmbach, the President's attorney, advising a staff member that Mr. Rebozo told him the President believed the fireplace in the library didn't draw well. Such a condition did not occur often and apparently was sourced in wind conditions. An exhaust fan was installed, purportedly necessary for fire prevention or security reasons, at a cost of $388.74. One of the President's staff wrote of convincing the Secret Service to pay for the fan "after I informed him that it definitely was placed for security purposes and how would he like it if you know who was asphixiated [sic] ever because there was a certain wind condition . . . ." *Id.* at EXHIBIT VII-6, A-568.
3. *See* STAFF REPORT, EXHIBIT VII-2 at A-563-64.
4. STAFF REPORT, EXHIBITS I-3, I-4, A-13-151. The first brief is in support of charitable deductions taken in connection with his 1969 gift of pre-Presidential papers and was prepared by Kenneth W. Gemmill and H. Chapman Rose, prominent tax attorneys in Washington, D.C. The second brief, prepared by Professor L. Hart Wright, Professor of Law at the University of Michigan, is directed solely at the effect on the charitable contribution deductions of Code § 170(a)(3) which denies a deduction for gifts of future interests. Professor Wright's scholarly analysis is exceptionally thorough and will be of immense assistance to any practitioner confronted with a charitable contribution involving donor reservations or restrictions.

The Staff Report analyzes numerous transactions and issues. Discussed below are the more significant transactions and issues: (1) the restriction on the gift of pre-Presidential papers, (2) the sale of the San Clemente property and allocation of basis between the property sold and that retained, (3) the sale of the President's New York apartment and nonrecognition of the gain upon the purchase of San Clemente, (4) the itemized deductions for business use of a residence, and (5) the personal use of government aircraft and expenditures of federal funds for improvements at San Clemente and Key Biscayne.

The first half of the analysis considers the gift of pre-Presidential papers.[5] The staff concluded that the President owned these papers but that there was no valid gift before July 25, 1969 when the Internal Revenue Code (hereinafter "Code") was amended to limit substantially the deductions applicable to gifts of such property. The staff also concluded that the gift was so restricted that it constituted a non-deductible gift of future interests.[6] The gift of the pre-Presidential papers constituted the largest single adjustment recommended by the staff. The papers were valued on the President's tax return at $576,000 and charitable deductions for the gift were taken in the amount of $482,018 from 1969 to 1972. The staff's analysis focuses on various facts and events surrounding the gift and the appraisal of pre-Presidential papers. Although this part of the analysis provides an interesting glimpse of the functioning of White House aides, a prominent appraiser and the National Archives, the factual analysis provides little substance which the practitioner might find useful.

The second largest recommended adjustment concerned the sale of certain property at San Clemente. The property, totaling about 30 acres, was purchased in 1969 at a cost of $1,529,393. In December of the following year 24 acres were sold for $1,249,000.[7] No capital gain was reported on the sale on the ground that the amount

5. STAFF REPORT at 10-94.
6. *See* INT. REV. CODE OF 1954, § 170(a)(3) [hereinafter cited as CODE]. *See* note 5 *supra.*
7. Sale of the property was to the B & C Investment Company which was formed by two close friends of the President, Bebe Rebozo and Robert Abplanalp. There might be some dispute about what actually was sold. *See* STAFF REPORT at 110 n.18. Subsequent to the sale the President had as much use and enjoyment of the land purportedly sold as he would have had without the sale. He continued to have use of the golf course and the entire 30 acres intended to be enclosed by a security fence. Thus, an argument could have been made that the President retained an interest in the property which would have required an allocation of basis.

of the original purchase price allocated to that portion of the property sold was exactly equal to the sales price so that no gain or loss resulted. The issue confronting the committee was whether the allocation of basis between property retained and property sold was appropriate. This is a recurring tax problem and the Staff Report examines the comparative sales technique as the applicable valuation approach. This, of course, is the most common allocation method and one which practitioners generally find best suited to their needs when comparable properties in the area have been sold in recent years. The report discusses allocations made in this manner by the President's accountant, the Internal Revenue Service, a national accounting firm and the committee staff. The staff severely criticizes the allocations made by the President's accountant and the national accounting firm and emphasizes some basic rules such as making the allocation based on fair market values at the time of purchase.

Whether the President was entitled to nonrecognition of the gain on the sale of his New York City residence under section 1034(a) involves another tax problem frequently encountered by the practitioner. In the President's case, the basic question was whether the San Clemente residence qualified as the principal residence of the President and Mrs. Nixon. The taxpayer's problem in this regard was complicated because he had not been paying California state income taxes and the State of California Franchise Tax Board determined that the Nixons were non-residents during the years 1969 through 1972.[8] During a 320 day period immediately following its purchase, Mr. Nixon and his family spent only 49 days (or 15 per cent of their time) at San Clemente—mostly on weekends and during vacation periods. Thus, the staff concluded that the taxpayer's principal place of residence was the White House, and recognition of gain on the sale of the New York City apartment could not be deferred under section 1034(a).[9] The Staff Report has no bind-

8. President Nixon was thus forced to maintain inconsistent positions. In order to justify nonpayment of California state income taxes he had to argue that he was a non-resident whereas nonrecognition of gain on the sale of his New York City apartment entailed arguing that San Clemente was his new principal place of business. The determination of state authorities is not binding on the Internal Revenue Service (or in this case, the joint committee) but many of the elements considered by the California authorities in reaching their decision also are applicable in determining whether San Clemente was President Nixon's principal residence within the meaning of CODE § 1034.
9. The Staff's analysis is not overly persuasive and one might wonder whether President Nixon could have sustained the burden of proving that San Clemente was his principal residence. The Staff felt that the "crucial facts" concerned the amount of time which President Nixon

ing precedential value,[10] but in a period of expanding leisure time, this portion of the report might serve as a warning to taxpayers who decide to sell their home and purchase retirement or recreational property for which they intend seasonal or intermittent use. If nonrecognition of gain is important, the taxpayer would be wise to establish residency wherever he purchases and to make substantial use of the property during the first few years of ownership.

A secondary issue in the sale of the New York City residence was the failure to reduce the adjusted basis of the property to reflect a business use.[11] The President's 1969 tax return stated that neither the New York City residence nor the San Clemente residence was used for business. The returns for 1965 through 1969, however, included deductions for 25 per cent of the maintenance cost of the New York City residence on the ground that it involved business use, and a similar percentage was deducted for maintenance costs at San Clemente in 1969.[12] This business use

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spent at the San Clemente property and concluded that the President and his family had not satisfied the statute's occupancy requirement. The staff fails, however, to evaluate fairly the amount of time spent by the President and his family at San Clemente. The 49 days spent at San Clemente should have been compared with time spent at the White House, Key Biscayne, Camp David and elsewhere. The Staff report unfairly suggests that the balance of President Nixon's time was spent at the White House when President Nixon in fact was frequently absent from the White House. Moreover, that President Nixon considered the White House his office rather than his home is evidenced by the fact that whenever the duties of his office permitted he left the White House. Indeed, one could conclude that whenever possible he returned to his principal place of residence at San Clemente.

10. *See* note 1 *supra.*
11. CODE § 1016 requires an adjustment to basis to take into account depreciation.
12. The Staff Report notes that there is no conclusive evidence that the incorrect statement on the 1969 return regarding no business use was intentional. STAFF REPORT at 114. The staff's use of a "conclusive" evidence test seems unjustly favorable to the taxpayer. Fraud, with its civil and criminal penalties, normally requires proof by "clear and convincing" evidence. Sidney W. Fairchild v. Commissioner, 462 F.2d 462 (3d Cir. 1972), *aff'g* 29 T.C.M. 1505 (1970). A "conclusive" evidence test arguably would constitute a much more difficult test for the Revenue Service to satisfy. Perhaps even more troublesome is the staff's recitation of certain "mitigating circumstances" which they concluded tended to explain the error. The purportedly mitigating circumstances consisted of a change of accountants in the year of sale and that in prior years' tax returns business expenses were listed in a manner that obscured the fact that the deductions were taken for business use of the apartment. For example, on the 1968 return $2,311.47 was deducted on Schedule C for "rent on business property,"

should have reduced the taxpayer's cost basis as a result of the depreciation of that portion of the apartment used for business purposes even though the taxpayer failed to claim these deductions.[13] Moreover, even if the nonrecognition provisions of section 1034 were deemed applicable, only that part of the gain allocable to the residential portion (75 per cent) qualifies for nonrecognition.[14] This is a complicating factor in the operation of section 1034 which probably is overlooked by a significant number of taxpayers who claim a deduction for home office expenses.

In addition to deducting 25 per cent of the cost of operating and maintaining the San Clemente residence, President Nixon also deducted 100 per cent of the operating costs (including depreciation) of one of his Key Biscayne residences[15] and certain guest fund expenditures totaling $132,053 which were primarily for food expenses while the first family was away from the White House. The staff viewed the operating cost expenses as nondeductible personal expenses.[16]

The staff recommended, however, the allowance of a deduction for depreciation of the office residence at Key Biscayne arguing that it was purchased for investment purposes. The staff supports

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while $920.49 was taken as a miscellaneous deduction for "office rent and maintenance." STAFF REPORT at 114. While it is true that the years prior to 1969 were not under consideration it is appalling that the staff would consider highly questionable reporting techniques in prior years as justification for misrepresentations in President Nixon's 1969 tax return. Under similar circumstances involving a less prominent taxpayer the Internal Revenue Service and its Justice Department litigators probably would argue that alleged misrepresentations on earlier returns demonstrate a continuity of conduct which ought to persuade a trier of fact that the misrepresentation in the later year was intentional.

13. CODE § 1016(a)(2) provides that an adjustment shall be made for depreciation allowed as a deduction in computing taxable income but "not less than the amount allowable" under the Code. *See* Virginia Hotel Corp. v. Helvering, 319 U.S. 523 (1943).
14. Treas. Reg. § 1.1034-1(c)(3)(ii) (1974).
15. The President purchased two adjoining residences at Key Biscayne, one reserved primarily for personal use and one purportedly used as an office, and 100 per cent of the operating cost of the latter arguably was deductible.
16. For example, the San Clemente residence is adjacent to a Coast Guard Station where the federal government constructed a Western White House at a cost of $1.7 million. The Western White House was located only 300 yards from the San Clemente residence and contained adequate office and meeting facilities for the President and his staff. The Key Biscayne deduction was more difficult but the staff concluded that the Government would have built an office at Key Biscayne had President Nixon so requested.

this recommendation on the ground that the President's family did not significantly use the residence and the President could have requested an office for business use. Perhaps the staff had additional undisclosed information regarding the President's intent in purchasing the residence, but the general thoroughness of the report suggests otherwise. Rather, the staff appears to have concluded that there was investment by default, a concept which might prove useful to taxpayers as a means of protecting maintenance expense deductions which might otherwise be disallowed.[17]

The personal use of government aircraft and government expenditures at Key Biscayne and San Clemente involve basic issues of what constitutes income. The discussion of economic benefit concepts should be particularly helpful to tax practitioners. A unique aspect of the President's situation is that the staff recommended that taxable income be attributed to him as a result of the use of government aircraft by friends and family members. The staff applies the doctrine of constructive receipt to determine who should be taxed on the income. Constructive receipt, of course, usually is involved with the question of when income is taxable. The critical element in the staff's recommendation appears to be that the President's family and friends had access to the government aircraft solely because of Nixon's employment as President. Thus, the President was considered to have constructively received the income.

When compensation is received other than in money the fair market value of the property must be included in income.[18] Conceivably the President could have been charged with the fair rental value of the government aircraft, but the staff recommended that income be based on first class commercial fares. It is highly unlikely, however, that other taxpayers will receive similar treatment. The Service's usual practice in determining constructive dividends resulting from the personal use of corporate facilities

17. For example, under CODE § 183 deductions may be severely limited if attributable to activities not engaged in for profit. An individual taxpayer may, however, deduct under CODE § 212 all ordinary and necessary expenses paid for the management, conservation, or maintenance of property held for the production of income. The determination of which section applies to a particular transaction is made by reference to objective standards taking into account all the facts and circumstances of each case. *See* Treas. Reg. 1.183-2(a) (1974). A viable investment by default concept would favor the applicability of CODE § 212. *See* Treas. Reg. § 183-1(d) (1974) regarding whether a taxpayer may be deemed engaged in two or more activities with regard to the same property so one activity would be treated under CODE § 212 whereas CODE § 183 would be applicable to another activity.

18. Treas. Reg. § 1.61-2(d) (1974). *See* Challenge Mfg. Co., 37 T.C. 650 (1962) and cases cited therein.

is to base income on the operating and fixed expenses applicable to such property.[19] The first class commercial rate was recommended because the President's family and friends were required because of their unique position to use government aircraft as a security precaution and because of the possibility of hijacking.

A similar analysis is involved in the staff's discussion of federal funds expended for improvements at Key Biscayne and San Clemente. The measure of income as the result of such improvements is the amount of personal economic benefit obtained from the expenditure when the employer's business purpose also is involved.

The report discusses many other issues, but an unstated issue relevant to the entire report concerns whether the taxpayer was treated unfairly or whether he was fortunate to be able to resolve his tax liability in this unique manner. There can be no conclusive answer to this issue. Too many facts are still unknown which would have a bearing on Nixon's tax liability. Moreover, the administrative resolution of tax disputes depends to a great extent on the advocacy skills of the respective parties and the resolution of problems of proof. Nonetheless, the author believes that President Nixon probably did not fare very well as a result of the arrangement he made to settle his tax liability. Although the report clearly concedes and compromises some issues, Nixon's tax experts probably could have negotiated a far better settlement if they had been able to appeal the report administratively as they normally would have done with a revenue agent's report.

The staff's report on the presidential tax returns is an unusual publication. It is an exceptionally thorough and well reasoned analysis of a number of tax problems encountered by the typical taxpayer. It is also an interesting examination of certain personal and business aspects of a highly controversial political figure and, in the final analysis is a damning statement of the quality and integrity of tax return preparers who must function within the highly complex set of rules set forth in the Internal Revenue Code.

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19. *See* Estate of William F. Runnels, 54 T.C. 762 (1970) (combining operating cost of automobile with depreciation to determine amount of contructive dividend).