

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

UNITED STATES OF AMERICA : CIVIL ACTION
(INTERNAL REVENUE SERVICE) :
Appellant, :
 :
v. :
 :
BASKIN & SEARS, P.C., et al., :
Appellee. : NO. 97-7201

MEMORANDUM

J. M. KELLY, J.

JUNE 30, 1998

Appellant, the United States of America, through the Internal Revenue Service ("IRS"), seeks to reverse several aspects of the decision set forth in the Memorandum Opinion of the Bankruptcy Court concerning the proof of claim of the IRS for 1988 taxes and the debtor's motion, under 11 U.S.C. § 505, for a determination of taxes due for 1990. The debtor corporation is a law firm initially known as Baskin & Sears, P.C., that practiced under several different names over the course of its existence. For the purpose of clarity, the Court shall refer to the debtor as "Baskin & Sears."

I. JURISDICTION AND STANDARD OF REVIEW

This court has jurisdiction over appeals from final judgements, orders and decrees from the bankruptcy court. 28 U.S.C. § 158. In an appeal from an order of the bankruptcy court, the district court conducts plenary review of legal conclusions and applies the clearly erroneous standard to factual findings. In re Brown, 951 F.2d 564, 567 (3d Cir. 1991).

II. FACTUAL BACKGROUND

Baskin & Sears initially started as a Pittsburgh law firm, but throughout its existence it tried to develop its presence as a regional law firm. At various times there were offices either part of or associated with Baskin & Sears in Harrisburg, Philadelphia, Washington, D.C., New Jersey and New York City. The firm achieved its high water mark when it absorbed a major defection from another Philadelphia law firm, establishing one of the largest law offices in Philadelphia. During 1989, the attorneys in the Washington, D.C. office separated from the firm, leaving the firm searching for another presence in the Washington, D.C. market. In early 1990, Baskin & Sears moved its Pittsburgh office and required Pittsburgh attorneys to commit to the new lease. As a result, the Pittsburgh office went from approximately 40 attorneys to approximately 20 attorneys. At the same time, accounting operations, including the firm's accounting manager, were moved from Pittsburgh to Philadelphia and a new computer system was purchased to do accounting tasks. Since the firm had the new computer, it stopped its practice of placing its accounting records on microfilm after March, 1990. The computer accounting system, however, never performed up to expectations. The accounting manager left Baskin & Sears to join another Philadelphia law firm after only a few months in Philadelphia. His position was never filled again. It is undisputed that after firm accounting operations were moved to Philadelphia, the

general ledger was never kept completely up to date and accounting functions were generally a disaster during 1990.

In early 1990, Baskin & Sears negotiated with a newly formed firm in Washington, D.C., Riley, Artabane, Winterhalter & Billings ("RAWB"), to become its Washington, D.C. affiliate. Under the proposed agreement, Baskin & Sears was to provide administrative services, including billing, payroll and accounting, to RAWB. RAWB's partners provided \$260,146 to Baskin & Sears, of which \$189,146 was eventually applied to the RAWB payroll, with the remainder returned to RAWB. As a result of Baskin & Sears' administrative problems, the affiliation never fully matured. While Baskin & Sears provided payroll services to RAWB, all other administrative duties were handled by RAWB.

Baskin & Sears ceased operating as a law firm on August 15, 1990. In February of 1991, after the bankruptcy proceeding had commenced, the building that contained the debtor's Philadelphia offices caught fire. Although the fire did not reach the floor where what remained of a Baskin & Sears office was located, much of the debtor's records were damaged by water used to extinguish the fire. Restoration efforts were able to recover over 80% of the debtor's records, however, there is some testimony within the record that the destroyed documents were particularly relevant to the 1990 taxes.

III. PROCEDURAL BACKGROUND

Although the firm had planned to liquidate after ceasing operations, the firm's creditors and some of its

shareholders filed an involuntary bankruptcy petition under Chapter 7 of the Bankruptcy Code. In November of 1990, Baskin & Sears converted the involuntary petition into a proceeding under Chapter 11 of the Bankruptcy Code. Baskin & Sears filed a reorganization plan that was confirmed by the Bankruptcy Court in May of 1993. The IRS filed a proof of claim asserting that the debtor had an income tax liability relating to tax year 1988. Baskin & Sears objected to the IRS' computation of the 1988 income taxes, and also moved for a determination of tax liability and possible refund for tax year 1990 under 11 U.S.C. § 505(b). The debtor's disagreement over the 1988 income taxes was premised on the loss carry back adjustment provision, 26 U.S.C. § 162, which would allow the debtor to carry back to 1988 a net loss the debtor had calculated for tax year 1990. The IRS disagreed, both with an adjustment of the 1988 taxes and with the debtor's determination of a net loss occurring in tax year 1990.

Baskin & Sears initially prepared its 1990 taxes by considering all of its bank deposits as income and adjusting income by previous percentages that represented amounts of expenses, which resulted in a reported net loss of \$1,484,544. The IRS found significant inter-account transfers and deducted those amounts from deposits to determine income. Where there were independent sources of evidence of expenses, such as payroll, the IRS utilized those records for expenses. Otherwise, the IRS generally relied upon the General Ledger as evidence of expenses, however, the IRS argued that expenses listed in the

general ledger for a Washington office and expenses for prepaid medical and malpractice insurance should not be allowed.

On July 19, 1995, the Bankruptcy Court commenced a proceeding to resolve the debtor's objection to the IRS' proof of claim and the debtor's motion for determination of tax liability and possible refund for tax year 1990. See 28 U.S.C. § 157(b)(2)(B). The trial was not completed, and after two days of testimony the court issued an order rescheduling the remainder of the trial for September of 1995. The court also directed the debtor to amend its 1990 return using the IRS' method of arriving at income and expenses. The debtor did so in August of 1995, submitting a Modified Analysis ("Amended Return") of its 1990 tax return.

The parties requested a continuance of the September trial and in November of 1995, informed the court that discovery was still on-going. Late in December of 1995 the IRS filed a response to the debtor's Amended Return. Based upon the IRS' analysis, the debtor still did not have a net loss for tax year 1990, but rather a tax deficiency amounting to \$582,880 plus penalties. In February of 1996, the IRS submitted a list of six issues that remained contested in the trial before the Bankruptcy Court.

The Bankruptcy Court held the second portion of the trial in March of 1996. In a Memorandum Opinion issued July 2, 1996, and a Final Order issued September 19, 1996, the Bankruptcy Court held that the debtor was entitled to take the deductions

for the Washington, D.C. office and for prepaid health and malpractice insurance. The court found that in tax year 1990 the debtor had a net operating loss of \$461,089 that resulted in a tax overpayment of \$40,800. In addition, the 1990 net loss could be carried back to tax year 1988, resulting in a tax refund for that year of \$15,908.

An appeal by the IRS followed. On appeal, the IRS argued that the Bankruptcy Court improperly placed the burden of proof upon the government, improperly allowed Baskin & Sears to deduct expenses related to a Washington, D.C. office and improperly allowed Baskin & Sears to deduct prepaid malpractice and health insurance expenses. This Court determined that the Bankruptcy Court had not articulated the standard that it applied in reaching its decision. Review of the Memorandum Opinion of the Bankruptcy Court indicated, and both parties believed, that the Bankruptcy Court used the bankruptcy standard of placing the burden upon the claimant in bankruptcy to prove its challenged proof of claim. See In Re Allegheny Int'l, Inc., 954 F.2d 167, 173-74 (3d Cir. 1992).

This Court held that the proper standard, even in bankruptcy, is that initially, a taxpayer bears the burden of proving that the assessment is "arbitrary and excessive" in order to require the IRS to prove that the assessment was correct. Otherwise, the taxpayer must overcome the presumption in favor of the government that a tax assessment was not erroneous. Resyn Corp. v. U.S., 851 F.2d 660, 663 (3d Cir. 1988). In Resyn, the

Third Circuit held that in bankruptcy a deficiency assessment by the IRS "is afforded a presumption of correctness, thus placing the burden of producing evidence to rebut that presumption on the taxpayer." 851 F.2d at 662-63. Since it was not clear what standard the Bankruptcy Court had applied, I vacated and remanded the order of the Bankruptcy Court to allow the Bankruptcy Court to either apply the burden of proof set forth in Resyn or to address the areas in its Memorandum Opinion where it appears that an incorrect burden of proof was applied. Using the burden of proof set forth in Resyn, the Bankruptcy Court issued a Memorandum Opinion on October 15, 1997, where it reached the same conclusions as it reached in its July 2, 1996 Memorandum Opinion.

IV. DISCUSSION

The IRS appeals the Bankruptcy Court's Order allowing \$513,307.74 of expenses claimed by Baskin & Sears, attributable to a Washington office, \$163,675.01 attributable to prepaid medical insurance and \$81,271.70 attributable to prepaid malpractice insurance.

A. Washington Expenses

The Bankruptcy Court allowed Baskin & Sears to deduct \$513,307.74 in expenses attributable to its Washington operation. The General Ledger shows \$437,644 attributable to payroll expenses for RAWB, as well as \$264,809.74 listed in the General Ledger, attributable to a Washington, D.C. office. The Bankruptcy Court deducted \$189,146 for RAWB payroll that was utilized from RAWB's contribution to Baskin & Sears. The IRS

argues that RAWB covered its own payroll expenses, therefore, a deduction for \$248,498 of RAWB payroll should not have been allowed. Further, since there was no Washington, D.C. office, the General Ledger entries for a Washington, D.C. office should not have been allowed.

In placing the current case within the framework of Resyn, it appears that the Bankruptcy Court required Baskin & Sears to prove its entitlement to the payroll expenses. Baskin & Sears presented proof that \$248,498 was paid by Baskin & Sears for RAWB payroll, during the pending affiliation with RAWB. The IRS tried to show that RAWB had a third account that funded its payroll payments, however, no records of this account were presented to the Bankruptcy Court. RAWB partners did testify that it fully funded its payroll, but those records could not be found. In fact, an RAWB partner testified that RAWB did not include payroll in its 1990 tax return. Based upon the evidence in the record, I cannot conclude that the Bankruptcy Court was clearly erroneous in allowing Baskin & Sears a \$248,498 deduction for RAWB payroll while the affiliation between the firms was pending.

The Bankruptcy Court allowed Baskin & Sears a deduction of \$264,809.74 in expenses for a Washington, D.C. office. The IRS argues that these expenses are not allowable because Baskin & Sears did not have a Washington, D.C. office in 1990. The Bankruptcy Court specifically found that these expenses were paid on behalf of RAWB as part of the contemplated affiliation between

the firms. The Bankruptcy Court did not accept the IRS argument that these expenses, derived from the General Ledger, should be rejected because RAWB paid its own bills and Baskin & Sears did not have a Washington, D.C. office. The Bankruptcy Court made a specific finding during trial that, at least at some point, Baskin & Sears and RAWB had formed a partnership. Under the Resyn test, it appears the Bankruptcy Court held that the IRS made an arbitrary decision to accept entries from Baskin & Sears' General Ledger as evidence of expenses, except for entries related to a Washington, D.C. office. Based upon the evidence in the record, I cannot hold that the Bankruptcy Court was clearly erroneous on this issue. While it is undisputed that the General Ledger was an incomplete record of Baskin & Sears' activities during 1990, the incompleteness relates to under-reporting income and expenses, rather than over-reporting as urged here by the IRS.

B. Insurance Expenses

The IRS also appeals the Bankruptcy Court finding that Baskin & Sears had established \$244,675.01 of prepaid malpractice and health insurance as legitimate expenses for 1990. The IRS argues that prepaid insurance for after Baskin & Sears stopped practicing law is not allowable as an expense because Baskin & Sears received no benefit from the expense. The IRS also argues that only about 33% of the reported medical insurance payments were actually made.

The IRS relies upon Jacobson v. Commissioner, 1983 WL 14706 (Tax Ct. 1983), for the proposition that a deduction for prepaid insurance must be prorated over the life of the policy. In Jacobson, however, the taxpayer purchased one year of insurance coverage and was required to prorate the expense month by month over two tax years. Here, Baskin & Sears purchased insurance for 1989 and 1990 and expensed the tax for those two years. It is well settled that a cash basis taxpayer such as Baskin & Sears may take deductions for expenses made within the tax year, but must prorate expenses that have a life over several years. The distinction between the present case and Jacobson lies with Jacobson's attempt to bring a subsequent year within the year when the payment was made. Here, the expense and the insurance are part of the same tax year and the insurance payments were properly expensed for 1990. The IRS tries to buttress its argument by arguing that Baskin & Sears shareholders received a benefit from the unused insurance. The Bankruptcy Court properly rejected this argument as there is no evidence in the record of this benefit to shareholders. The IRS also argued that the insurance may be subject to a refund. There is no evidence of such a refund received in 1990 and if a refund was received in some later year, the tax consequences of that refund are properly resolved once the refund is received.

The IRS argues that Baskin & Sears has not proved that two-thirds of \$163,675.01 of prepaid medical insurance payments were ever made. Baskin & Sears relies upon General Ledger

entries automatically expensed over the course of the year and check memos to prove these expenses. The IRS counters that review of Baskin & Sears' bank statements reveals that two-thirds of the medical insurance payments were never paid. The Bankruptcy Court ordered Baskin & Sears to identify these contested payments in the bank statements, however, no evidence of these payments has been placed before this Court. Based upon Baskin & Sears' failure to locate the ordered evidence of these payments, the Court finds that the Bankruptcy Judge was clearly erroneous in allowing deductions for all of the medical expenses. While the exact amount of the unpaid medical insurance payments has not been placed before this Court, Baskin & Sears has not disputed the IRS's two-thirds calculation. Accordingly, the Court shall reverse and remand this portion of the Bankruptcy Court's Memorandum Opinion with instructions to allow Baskin & Sears to take a deduction of \$54,558.37 for prepaid medical insurance, as opposed to the \$163,675.01 allowed by the Bankruptcy Court.

CONCLUSION

The Memorandum Opinion is reversed as to Baskin & Sears' deduction of \$163,675.01 for medical insurance expenses. This matter is remanded to the Bankruptcy Court which is ordered to allow Baskin & Sears to take a deduction of \$54,558.37. Since there is insufficient information before this Court to allow a revision in Baskin & Sears' 1990 and 1988 tax returns, the Bankruptcy Court is instructed to make the appropriate change, if

any. The Memorandum Opinion of the Bankruptcy Court is affirmed in all other respects.

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ORDER

AND NOW, this 30th day of June, 1998, upon consideration of the Appeal of the United States of America, the Response of Debtor/Appellee Baskin & Sears, P.C., et al. ("Debtor"), the Reply thereto of Appellant, and the record in this matter, it is ORDERED:

1. The Memorandum Opinion and Order of the Bankruptcy Court are REVERSED IN PART. This matter is REMANDED to the Bankruptcy Court to allow Debtor a \$54,558.37 deduction for

prepaid medical insurance and to make the appropriate change, if any, in Debtor's 1988 and 1990 Federal Tax Returns.

2. The Memorandum Opinion and Order of the Bankruptcy Court is AFFIRMED in all other respects.

BY THE COURT:

JAMES MCGIRR KELLY, J.