2006

Recent Developments in Federal Income Taxation

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This recent developments outline discusses, and provides context to understand, the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide my co-author the opportunity mock our elected representatives. The outline focuses primarily on topics of broad general interest [to the two of us, at least] – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; my co-author and I take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. This outline is in 12-point type because of your advancing ages.

I. ACCOUNTING

A. Accounting Methods

1. Rev. Proc 2006-11, 2006-3 I.R.B. 309 (12/21/05). Procedures by which taxpayers may request accounting method changes so they can comply with § 263A cost capitalization under the simplified service cost method and the simplified production method contained in regulations set forth in T.D. 9217.

2. T.D. 9217, Guidance Regarding the Simplified Service Cost Method and the Simplified Production Method, 70 F.R. 44467 (8/3/05).

3. **Tax Court rules that trader in securities failed to make timely mark-to-market election.** Lehrer v. Commissioner, T.C. Memo. 2005-167 (7/11/05). The taxpayers (in an amended petition to the Tax Court) sought to make an election under § 475(f) to treat the trading losses as ordinary losses instead of capital losses, which would have substantially reduced the IRS assessments for the three years involved. The IRS argued that even if Mr. Lehrer was a "trader in securities" during the years in issue, he failed to make an effective mark-to-market election under § 475(f) pursuant to Rev Proc 99-17, 1999-1 C.B. 503, and petitioned the Tax

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Court for summary judgment. The Lehrers conceded that they did not make a mark-to-market election on their tax returns but argued that an effective mark-to-market election was made on their first amendment to petition the Tax Court. Further, the Lehrers argued that Rev Proc 99-17 lacks "precedential value as it simply announces the Service's position."

- The Tax Court further stated:

> A taxpayer engaged in a trade or business as a trader in securities is eligible to elect to recognize gain or loss on any security held in connection with his trade or business at the close of the taxable year as if the security were sold for its fair market value at year end. Sec. 475(f)(1)(A)(i); see Chen v. Commissioner, T.C. Memo. 2004-132. In general, any gains or losses resulting from the mark-to-market election shall be treated as ordinary income or loss. Sec. 475(d)(3)(A), (f)(1)(D). If a taxpayer is in the business as a trader in securities and made a mark-to-market election with respect to sales of securities held in connection with his business, his net loss from that business would be an ordinary loss, deductible in full under section 165; if the mark-to-market election is not made, the net loss would be a capital loss deductible only to the extent of any capital gains plus $3,000. See secs. 165(a), (c), (f), 1211(b)(1); Chen v. Commissioner, supra.
>
> In Chen, we held that the taxpayer was not a 'trader in securities' for the relevant year for purposes of section 475(f) and, therefore, did not address the taxpayer's argument regarding whether he should be permitted to make an untimely, retroactive mark-to-market election because section 475(f) was not available to him. As a result, we are presented with a novel issue: whether an allegation contained in an amendment to petition qualifies as an effective mark-to-market election. The statute and regulations do not provide procedures that specify the time and manner to make a mark-to-market election. *** The legislative history states that 'The election will be made in the time and manner prescribed by the Secretary of the Treasury and will be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary.' See H. Conf. Rept. 105-148, at 446 (1997), 1997-4 C.B. (Vol. 1) 323, 768. Thus, the Secretary has authority to prescribe the time and manner of the election."

a. But another taxpayer who failed to make a timely mark-to-market election under § 475 election is granted relief by the Tax Court. Vines v. Commissioner, 126 T.C. No. 15 (5/11/06). Taxpayer was a Birmingham, AL plaintiffs' lawyer who settled a class action lawsuit during 1999 and received compensation of about $17 million in each of the years 1999 and 2000. In 2000, he decided to leave the practice of law and begin a business of trading securities; between January 28 and April 14, 2000 [the day his trading account was liquidated for failure to cover a margin call after technology stocks declined], he had net trading losses of more than $25 million. He did not make a § 475(f) election with his application for automatic extension of his 1999 income tax return, which was filed timely on April 17, 2000, because neither he nor his CPA was aware of the applicability of that provision. In June 2000, he became aware of a possibility of deducting his trading losses as ordinary losses, and promptly sought § 9100 relief from the April 17th due date that was prescribed in Rev. Proc. 99-17, 1999-1 C.B. 503, for the filing of Form 3115 to adopt the mark-to-market method for his securities trading business. Judge Wells granted relief under Reg. § 301.9100-3(c) because taxpayer made no securities trades between April 14 and the July 21 date on which he filed his § 475(f) election, and therefore gained no advantage or benefit of hindsight from the delay.

4. **Accountant's persistent omission of a step in the computation of the LIFO value of inventories required a change of accounting method to correct.** Huffman v. Commissioner, 126 T.C. No. 17 (5/16/06). Correction to the inventory method employed by S corporations that owned automobile dealerships constituted an accounting method change that requires a § 481 adjustment, and was not simply the correction of a mistake in arithmetic. Judge Halpern held this to be an accounting method change because the accountant reached an erroneous result over a 10- to 20-year period by omitting a computational step required by Reg. § 1.472-8, related to the link-chain, dollar-value method of pricing LIFO inventories, which caused understatements and overstatements in the LIFO value of inventories but did not result in the permanent omission of gross income.

- The correction of an erroneous formula -- one that omitted a step for calculating inventories under the link-chain, dollar value method of valuating inventory over a 10 to 20 year period – resulted in the error being a timing error, not a mere computational error. Generally, corrections to the taxpayer's inventory accounting method constitute a change of accounting method. Furthermore, correction of a systematic erroneous method of calculating inventories on a recurring basis without a change in the overall inventory method, constitutes a change of accounting method rather than the correction of a computational error.

B. Inventories

C. Installment Method

D. Year of Receipt or Deduction

1. Hightower v. Commissioner, T.C. Memo. 2005-274 (11/28/05). Funds received pursuant to arbitrator's decision regarding forced-buyout of corporate stock were includable in income, even though taxpayer continued to contest the decision, because he accepted the check, endorsed it, and deposited the proceeds in an interest bearing account under his sole control. Taxpayer's creation of a separate account did not evidence unconditional renunciation of right to funds.

2. **The writer of a put option does not have income until the year the option expires unexercised.** Federal Home Loan Mortgage Corporation (Freddie Mac) v. Commissioner, 125 T.C. No. 12 (11/21/05). The Tax Court (Judge Ruwe) held that nonrefundable commitment fees that loan originators pay to Freddie Mac are not income in the year of receipt to Freddie Mac; instead, they are premiums for put options and should be treated as such for tax purposes, i.e., they reduce taxpayer's basis in the loans purchased if the option is exercised and they are income in the year the option lapses if the option is not exercised. The premium received by the writer of a put option that is not exercised is ordinary income for the taxable year in which the failure to exercise the option becomes final; if a put option is exercised, the premium received by the writer is an offset against the option price, which reduces the basis of the property acquired pursuant to the put option. (commitment fees received from mortgage loan originators by taxpayer under contracts with mortgage originators that obligated taxpayer to purchase mortgages from originators during a specified period of time pursuant to a pricing formula, but which did not require the originators to sell mortgages to taxpayer were options; option does not require a fixed price)

- The Commissioner argued that the nonrefundable portion of commitment fees were income in the year of receipt under the all events test of § 451.

3. **Anticipated warranty expenses are not deductible in the year taxpayer sold warranted motor vehicles.** Chrysler Corp. v. Commissioner, 436 F.3d 644,

2006-1 U.S.T.C. ¶50,155 (6th Cir. 2/8/06), *aff'g* T.C. Memo. 2000-283 (8/31/00). Held, taxpayer was not permitted to deduct anticipated warranty expenses in the year it sold warranted motor vehicles to its dealers because the warranty claims had not yet been made. The court followed *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), and distinguished *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986), when it followed the tax court in holding that the last event in the fixing of petitioner's liability occurred no sooner than when a warranty claim was filed with petitioner by one of its dealers or by the retail customer.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **The IRS changes position on the tax treatment of rebates.** Rev. Rul. 2005-28, 2005-19 I.R.B. 997 (4/25/05). This ruling holds that a payment made by a seller to a purchaser, the purpose and intent of which is to reach an agreed-upon net selling price, is treated as an adjustment to the sales price rather than a deduction item. Therefore, Medicaid rebates incurred by a pharmaceutical manufacturer are purchase price adjustments that are subtracted from gross receipts in determining gross income.

- Rev. Rul 76-96, 1976-1 C.B. 23, which held that an automobile manufacturer's rebates paid to retail customers are deductible as ordinary and necessary business expenses under § 162, is suspended in part because the issue is being reconsidered by the IRS.

a. REG-131264-04, Withdrawal of Proposed Regulations Regarding Intercompany Transactions; Manufacturer Incentive Payments, 71 F.R. 26721 (5/8/06). Withdraws proposed regulations, REG-131264-04, 69 F.R. 50112 (8/13/04), regarding the treatment of manufacturer incentive payments, in light of the changed position reflected in Rev. Rul. 2005-28. T.D. 9261, Intercompany Transactions; Manufacturer Incentive Payments, 71 FR 26687, removes an example [#13] involving manufacturer incentive payments from Reg. § 1.1502-13(c)(7)(ii) for the same reason.

2. **Supplier's advances are immediately includible in income.** Karns Prime & Fancy Food, Ltd. v. Commissioner, T.C. Memo. 2005-233 (10/5/05) A $1.5 million advance received by the taxpayer-retailer from a supplier that was evidenced by a promissory note with the proper indica of debt nevertheless was not a true debt, because the parties concurrently entered into a supply agreement pursuant to which the debt would be forgiven if the taxpayer purchased the quantity of product required under the supply agreement over its term; in substance, there was no unconditional obligation to repay the advance because the amounts under the note were due only if the supply agreement was materially breached by taxpayer.

a. **The Ninth Circuit disagrees.** Westpac Pacific Food v. Commissioner, 451 F.3d 970 (9th Cir. 6/21/06), *rev'g* T.C. Memo. 2001-175 (7/16/01). "Cash advance trade discounts" received by a retailer from a manufacturer in exchange for volume purchase commitments, subject to pro rata repayment if the volume commitments were not met, were not includable in gross income when received because these amounts were adjustments to cost of goods sold and the cash advances were includible in income by virtue of taxpayer's inventory accounting system.

3. Coburn v. Commissioner, T.C. Memo. 2005-283 (12/6/05) Debtor's release of collateral to creditor did not give rise to income from discharge of indebtedness income because taxpayer-debtor remained liable for the balance of the debt.

4. **Taxpayer has COD income when liabilities are discharged by a guarantor's payment to the creditor after waiving any right to reimbursement from the taxpayer.** Miller v. Commissioner, T.C. Memo. 2006-125 (6/15/06). Taxpayer-debtor realized COD income upon guarantor's payment of debt to the creditor because guarantor had waived any right to reimbursement rights in advance. Judge Gale further held that liabilities the cancellation of which give rise to COD income are counted in full as liabilities even though, because taxpayer was insolvent and loan was guaranteed by a solvent third party, there was virtually not likelihood that taxpayer-debtor would be called upon to pay them. The primary obligor on a recourse obligation is "at-risk" notwithstanding a guarantor's waiver of right to reimbursement because the creditor had the right to enforce loan against taxpayer, and taxpayer had no rights to reimbursement from any other person. The fact that taxpayer was insolvent when the loan fell due and the creditor sought repayment directly from the guarantor was not relevant.

B. Deductible Expenses versus Capitalization

1. **IRS identifies issues to be addressed in forthcoming proposed regulations on tangible property costs.** Notice 2004-6, 2004-3 I.R.B. 308 (12/22/03). These issues include [using the numbering from the Notice]: (1) What general principles of capitalization should be applied? (2) What is the appropriate "unit of property"? (3) What is the starting point for determining whether property value is increased or useful life is prolonged? (11) Should the regulations provide "repair allowance" type rules? (12) Should the regulations provide a *de minimis* rule? (13) When should the "plan of rehabilitation" doctrine be applied? (15) Are there circumstances where tax treatment should follow financial or regulatory accounting treatment?

a. **At long last, the long-promised tangible property proposed regulations are out.** REG-168745-03, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 71 F.R. 48590 (8/21/06). Provisions include a repair allowance system that would permit expenditures on each class of property up to a specified percentage of cost to be deducted as repairs, with any excess required to be capitalized; the percentage is to be determined based on the principle that a taxpayer will spend 50 percent of cost on repairs over the MACRS recovery period. There are other rules, such as a twelve-month rule, unit-of-property rules for four categories of property [regulated industry property, buildings and structural components, other personal property, and other real property], but there is no de minimis rule – however, the absence of a de minimis rule does not change the current practice of permitting agreements between taxpayers and IRS examining agents not to select assets with minimal cost for review. Amounts paid that materially increase the value of a unit of property must be capitalized, as must be amounts paid that substantially prolong economic useful life.

- The repair allowance rules in these proposed regulations are similar to those in the class life asset depreciation rules (CLADR), which were in effect from the late 1960s to 1980 (when they were superseded by ACRS).

2. Tigrett v. United States, 96 A.F.T.R.2d 2005-5649 (W.D. Tenn. 8/3/05), *as amended*, 9/2/05. Amounts paid to corporation by president/minority shareholder of a corporation in satisfaction of his contractual obligation to indemnify corporation against losses from a specific venture that he advocated corporation undertake constituted a capital contribution, not a business expense, because taxpayer had no possibility of personal business profit from the specific venture by the corporation.

3. Rev. Rul. 2005-47, 2005-32 I.R.B. 261. Credit card issuers treat third-party ATM surcharge fees incurred by their cardholders as additional amounts loaned to those cardholders.

4. Anschultz Co. v. Commissioner, T.C. Memo. 2006-40 (3/13/06), *reconsideration denied*, T.C. Memo 2006-124 (6/14/06). The taxpayer properly made a first level allocation under Reg. §§ 1.263A-1(e)(3)(i) and 1.451-3(d)(6)(i) of indirect costs between (1) property produced under long-term contract [which was not subject to § 263A], and (2) property produced and held by the taxpayer for its own use [which was subject to § 263A]. Judge Haines held that the "reasonableness" standard of Reg. § 1.263A-1(f)(4) does not apply to interpret "reasonable allocation" in Reg. § 1.451-3(d)(6)(i) when only § 460 is at issue.

C. Reasonable Compensation

D. Miscellaneous Deductions

1. **The IRS never seems able to catch up with the movements in the price of gasoline, and more tinkering is in store for 2005.** Rev. Proc. 2004-64, 2004-49 I.R.B. 898 (11/17/04), *superseding* Rev. Proc. 2003-76, 2003-43 I.R.B. 924. The optional standard mileage rate for business use of automobiles will increase on 1/1/05 from 37.5 cents per mile to 40.5 cents per mile; the mileage rate for medical and moving will increase from 14 cents per mile to 15 cents per mile; and the mileage rate for giving services to a charitable organization will remain at 14 cents per mile.

- Query whether increasing the deduction for driving to the doctor so it is now greater than the deduction for driving to the charitable board meeting — in 2003, the deduction for medical mileage was less than charitable mileage — is because many more taxpayers deduct charitable miles than medical miles?

a. **The IRS noticed that fuel prices went up recently, so a 9/1/05 increase in mileage rates is announced.** Announcement 2005-71, 2005-41 I.R.B. 714 (9/9/05). On 9/1/05, the optional standard mileage rate for business use of automobiles will increase to 48.5 cents per mile, and the standard mileage rate for medical and moving expenses will increase to 22 cents per mile. The rate for charitable miles remains at the statutory [§ 170(i)] 14 cents per mile.

b. Under the **Katrina Tax Act**, the charitable standard mileage rate would be 70% of the standard mileage rate for businesses if the use of the vehicle is for the purpose of providing relief related to Hurricane Katrina. Effective for the use of a passenger automobile between 8/25/05 and 12/31/06.

c. **Splitting the difference between the first eight months of 2005 and the last four for 2006.** Rev. Proc. 2005-78, 2005-51 I.R.B. (12/2/05). Mileage rates effective on or after 1/1/06 are as follows: business, 44.5 cents per mile; medical and moving, 18 cents per mile; general charitable contribution deduction, 14 cents per mile (statutory); Hurricane Katrina charitable contribution deduction, 32 cents per mile (with a Hurricane Katrina charitable use of automobile reimbursement rate permitted without income effect of up to 44.5 cents per mile).

2. Section 201 of the **Jobs Act of 2004** amends § 179 to extend the $100,000 amount for expensing [and the $400,000 phase-out threshold] for small businesses through years beginning before 2008.

a. Rev. Proc. 2005-70, §3.18, 2005-47 I.R.B. 979. The amount is indexed for inflation, and for taxable years beginning in 2006 the amount a taxpayer may elect to expense under § 179 cannot exceed $108,000, and the phase-out threshold begins at $430,000.

b. **Final § 179 regulations.** T.D. 9209, Section 179 Elections, 70 F.R. 40189 (7/13/05). Modified to take into account the increased limits of the Jobs Act, which apply to taxable years beginning in 2003 through 2007.

- Time For Making or Revoking 179 Election Under New Regs. (Reg. § 1.179-5(c)(1)). For any taxable year beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for such taxable year.

- Planning Note: Reg. § 1.179-5(c) does not remove the general rule contained in Reg.§ 1.179-5(a) which says the election shall be made on the taxpayer's first tax return. In other words, a taxpayer who files a tax return 4 years after the return is due may make a § 179 election on that return even though the return is not timely. Reg. § 1.179-5(c) seems to allow a § 179 election or the revocation of a § 179 election on an amended return as an additional option for years beginning after 2002 and before 2008.

- May Elect § 179 When IRS Capitalizes "Repairs," Etc. Taxpayers who expense items for tax years 2003 through 2007 that are later capitalized as fixed assets by the IRS, may elect § 179 on the capitalized items assuming the § 179 limitations have not been exceeded, and the statute of limitations has not run on the year the property was placed-in-service.

c. **Increased § 179 amount extended through 2009. TIPRA** § 101 amends § 179 to extend the increased amount for expensing through years beginning before 2010.

3. **This deduction should prove so effective that it will be extended to all business income.** Section 102 of the **Jobs Act of 2004** adds new § 199 to provide a nine percent deduction for U.S. manufacturing income, i.e., "income attributable to domestic production activities." For corporations, the deduction allowed by § 199 is a percentage of the lesser of "qualified production activities income" or taxable income. For individual taxpayers engaged in manufacturing, the taxable income limitation is replaced by a limitation based on adjusted gross income. The deduction will be phased in over six years, beginning with 2005. The percentage begins at three percent for 2005 and rises to nine percent after 2009, but in no event can the deduction exceed 50 percent of the W-2 wages paid by the taxpayer during the year for which the deduction is sought. § 199(a) and (b). Thus, the deduction is unavailable to a sole proprietor or partnership with no employees. Although the deduction is available to individuals, corporations, and pass through entities, only items attributable to the conduct of a trade or business can be taken into account. § 199(d)(5).

- Qualified production activities income is defined as the excess of "domestic production gross receipts" over the sum of (1) the cost of goods sold allocable to domestic production gross receipts, (2) other deductions, expenses, or losses directly allocable to domestic production gross receipts, and (3) a ratable portion of other deductions, expenses, and losses not directly allocable to domestic production gross receipts or to any other class of income. § 199(c)(1). Domestic production gross receipts are gross receipts derived from (1) the lease, rental, license, or sale, exchange, or other disposition of (a) "qualifying production property", defined as tangible personal property, computer software, and sound recordings, produced (in whole or in significant part) by the taxpayer in the United States, (b) a "qualified film" produced by the taxpayer, or (c) electricity, natural gas, or potable water produced by the taxpayer in the United States; (2) construction performed within the United States, or (3) architectural or engineering services performed in the United States for United States construction projects. Section 199(c)(4)(B) excludes from the definition of domestic production gross receipts any receipts from (1) the sale of food and beverages prepared by the taxpayer at a retail establishment, or (2) the transmission or distribution (as contrasted with the production) of electricity, natural gas, or potable water.

- Because the deduction is a percentage of a specified type of net income, rather than an allowance for actual expenses incurred by the taxpayer, its effect can be viewed as reducing the effective tax rate on qualified production activities income. (Indeed, it originated in a proposal to reduce the corporate tax rate generally, but through the legislative process metamorphosed into its current structure.) Suppose a taxpayer has $100,000 of qualified production activities income and sufficient income from other sources to be subject to a marginal rate of 35 percent (the highest statutory rate for both individuals and corporations). The § 199 deduction reduces the taxpayer's taxable income derived from qualified production activities from $100,000 to $91,000. At 35 percent, the tax on $91,000 is $31,850, which is an effective tax rate of only 31.85 percent on the $100,000 of qualified production activities income.

- Section 199 is unique in allowing a deduction equal to a portion of *net* income generated by a general type of business activity. Most tax expenditures for businesses accelerate deductions, provide deductions for amounts not otherwise deductible, allow a deduction related to gross income from a specified activity, or take the form of a credit. Most tax experts believe the provision to be so complex, and the distinctions and pigeon-holing of sources of income and the purpose for which deductible expenditures were incurred that are required to calculate the amount of the deduction to be so difficult to ascertain, that the provision cannot be reasonably and consistently administered.

- This provision resulted from efforts to retain some of the tax expenditure benefits provided to exporters by the extraterritorial income ("ETI") regime that, like the domestic international sales corporation ("DISC") and the foreign sales corporation ("FSC") regimes before it, were found to violate U.S. obligations under international trade agreements. Because the objectionable feature of the ETI, FSC, and DISC regimes was that they provided tax benefits only for certain export activity and were thus found by the World Trade Organization to provide for prohibited export subsidies, the new deduction applies regardless of whether the manufactured goods are exported. The deduction of extraterritorial income (ETI), will be eliminated in 2007 after being phased out in 2005 [80 percent deduction] and 2006 [60 percent deduction]. A WTO panel has found the phase-out to be itself in violation of international trade agreements.

a. **If the statute appears to have a short shelf-life, the guidance under it should be even more ephemeral.** Notice 2005-14, 2005-7 I.R.B. 498 (1/19/05). Lengthy guidance on the new manufacturing deduction. Pending promulgation of what surely will be voluminous regulations governing the allocation of deductions, expenses, and losses for the purpose of calculating qualified production activities income, Notice 2005-14 provides interim guidance.

b. **Proposed regulations.** REG-105847-05, Income Attributable to Domestic Production Activities: Deduction, 70 F.R. 67220 (11/4/05). Massive [224 pages] proposed regulations [§§ 1.199-1 through -8] relating to the deduction for U.S. manufacturing income under § 199.. The "shrinking back" concept of taking the deduction for only the value of the beans in a cup of brewed coffee, or for the value of the U.S.-manufactured shoelaces on a pair of foreign-manufactured sneakers is being much discussed.

c. **Finally, final regulations! Final § 199 regulations are out and are 247 pages long, but that is only 137 pages in Lexis and 55 pages in the Federal Register.** T.D. 9263, Income Attributable to Domestic Production Activities, 71 F.R. 32168 (6/1/06). You have to be addlepated if you expect a summary.

d. **"W-2 wages" include only those allocable to domestic production activities. TIPRA** § 514 amends § 199(b) to provide that "W-2 wages" includes only wages properly allocable to domestic production gross receipts.

e. Rev. Proc. 2006-22, 2006-23 I.R.B. 1033 (5/24/06). Guidance for calculating W-2 wages that reflects the additional limitations imposed by **TIPRA**. Three methods are provided for the calculation, the unmodified box method, the Modified Box 1 method, and the tracking wages method.

4. **Tool allowance is not paid under an accountable plan.** Rev. Rul. 2005-52, 2005-35 I.R.B. 423 (8/3/05). A tool allowance paid by an employer in the automobile repair and maintenance business to its service technicians based upon the numbers of hours worked by each service technician is not an accountable plan such that the payments are excluded from the employees' gross income and exempt from the withholding and payment of employment taxes because it fails to meet both the "substantiation" and the "return of excess" requirements (although it does meet the "business connection" requirement). (a set amount for each hour worked paid by an automobile repair business to employee-mechanics, who were required to purchase their own tools, as a "tool allowance" was includable in gross income an itemized employee business expense deduction, because employees were not required to provide any substantiation of expenses incurred for tools and employer did not require employees to return any portion of the tool allowances that exceeded their actual expenses).

a. **To the same effect.** Namyst v. Commissioner, T.C. Memo. 2004-263 (11/17/04). Reg. § 1.62-2(f) conditions application of the netting rule [permitting an above-the-line deduction of employee business expenses pursuant to an accountable plan] on the employee being required to return excess advances to the employer. The taxpayer, instead, was required to include expense reimbursements in gross income because although he was required to [and did meticulously] account to the employer for his expenses, the taxpayer was not obligated to return any excess advances to the employer.

(1) **Affirmed**. Namyst v. Commissioner, 435 F.3d 910, 2006-1 U.S.T.C. ¶50,163 (8th Cir. 1/27/06). These payments did not meet the standards set forth in Reg. § 1.62-2 for payments to qualify as being part of an "accountable plan" because the payments were not differentiated between reimbursements of expenses and for payments with respect to tools. The court affirmed the Tax Court's refusal to treat substantiated payments as made under a qualified accountable plan while treating unsubstantiated payments as payments under a nonaccountable plan because the plan as a whole must meet the requirements of an accountable plan for such treatment.

5. **The deduction for the cost of clothing purchased under a "once-wear" policy was disallowed because the clothing was not unsuitable for personal wear.** Deihl v. Commissioner, T.C. Memo. 2005-287 (12/15/05). The Tax Court (Judge Wherry) held *inter alia* that clothing to be worn only once at conventions or other promotional meetings was not deductible under the test that it must be "not suitable for general or personal wear" as applied objectively. The clothing would not meet that test under a subjective methodology because the court found taxpayer's testimony to that effect "overly broad and exaggerated." *Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980), followed.

6. **No current taxation of settlement funds beneficially owned by a governmental entity. TIPRA** § 201(a) added Code § 468B(g)(2) and (3), which provides that certain settlement funds established before 2011 pursuant to consent decrees in order to resolve claims under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) are treated as beneficially owned by a state or federal governmental entity, and are thus exempt from tax under § 468B(g)(1).

7. **This case applies the reimbursement doctrine twice.** Transport Labor Contract/Leasing, Inc. v. Commissioner, 2006-2 U.S.T.C. ¶50, (8th Cir. 8/23/06). Taxpayer provided professional employer organization ("PEO") services to small and medium-sized trucking companies by hiring truck drivers as its employees and then leasing them back to its trucking company clients. The issue was whether it or the trucking company had to take the § 274(n) haircut when the drivers were paid a fixed per diem, with the per diem being treated as an expense reimbursement. The Tax Court held that the PEO was the common law employer, and stopped there. The Eighth Circuit (Judge Loken) reversed as a matter of law on the ground that the § 274(e)(3)(B) exception applied because the taxpayer itself incurred the per diem expenses "under a reimbursement or other expense allowance arrangement" with the trucking companies for which it accounted to them.

E. Depreciation & Amortization

1. Section 1245(b)(9), added to the Code by the **Energy Tax Incentives Act of 2005**, provides that if a taxpayer disposes of several § 197 intangibles in one transaction, or in a series of related transactions, all the intangibles are treated as a single asset for purposes of calculating § 1245 recapture.

2. **TIPRA** § 207 adds new § 167(g)(8) to provide for the election of 5-year amortization of costs of musical compositions and copyrights placed in service during years beginning after 2005 and before 2011. A taxpayer not making the election may use any cost recovery method otherwise permitted, including the income forecast method.

F. Credits

1. The **Katrina Tax Act** provides a "Work Opportunity Tax Credit" for Hurricane Katrina employee survivors and an "employee retention credit" for employers affected by Hurricane Katrina.

2. Section 41(b)(3)(D), added to the Code by the **Energy Tax Incentives Act of 2005**, permits taxpayers to take into account 100 percent of contract research expenses paid to eligible small businesses, universities, and federal laboratories.

3. Section 41(a)(3), added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit equal to 20 percent of a taxpayer's share of the expenses of an "energy research consortium." To be qualified, a consortium must be an organization described in § 501(c)(3), and must have received payments (including contributions) from at least 5 unrelated

persons during the calendar year (with no more than half of the payments coming from any single person). In contrast with the usual rule under § 41, the energy research consortium credit applies to all described expenditures, rather than only to expenditures in excess of some base amount.

4. Notice 2006-38, 2006-16 I.R.B. 777 (3/23/06). Advises taxpayers that they have a reasonable period [deemed to be up to 36 months] to repair and restore qualified rehabilitated buildings located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone, as defined in § 1400M(1), (3) and (5), respectively, in order to avoid recapture of previous credits taken.

G. **Natural Resources Deductions & Credits**

1. The **Energy Tax Incentives Act of 2005** classified natural gas gathering lines as seven-year property. IRC § 168(e)(3)(C)(iv).

2. The **Energy Tax Incentives Act of 2005** added two new classes of fifteen-year property: (1) section 1245 property used in the transmission of electricity at 65 or more kilovolts, and (2) certain natural gas distribution lines, IRC §§ 168(e)(3)(E)(vii), 168(e)(3)(E)(viii).

3. **FIRST: Energy efficient commercial buildings; "greening-up" an existing building.** Section 179D, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a deduction for the cost of "energy efficient commercial building property" placed in service during 2006 or 2007. Qualified property must be installed in a building within the United States as part of (1) the interior lighting systems, (2) the heating, cooling, ventilation, and hot water systems, or (3) the building envelope, and must be certified as being installed pursuant to a plan designed to reduce the building's total annual energy and power costs by at least 50 percent in comparison to a hypothetical reference building. The deduction may not exceed $1.80 per square foot of the property. The statute directs the Treasury Department, in consultation with the Department of Energy, to promulgate regulations setting forth methods of calculating and verifying energy and power costs. In the case of an expenditure made by a public entity (such as a public school), the statute directs the Treasury Department to promulgate regulations allocating the deduction to the designer of the property in lieu of the owner.

- If a building does not satisfy the overall 50 percent reduction standard, a partial deduction (limited to $0.60 per square foot) is allowed for system-specific energy efficient property, if a specific system (i.e., (1) interior lighting, (2) heating, cooling, ventilation and hot water, or (3) building envelope) satisfies system specific targets to be established by regulation (with the statute providing an interim target, in the case of lighting system retrofits).

4. The **Energy Tax Incentives Act of 2005** liberalized § 613A(d)(4); the new limit is 75,000 barrels per day, and it is based on average daily production for the entire year rather than maximum daily production on any day.

5. **G&G in the U.S. gets 24-month amortization, except for major oil companies.** Under new § 167(h), added to the Code by the **Energy Tax Incentives Act of 2005,** amounts incurred in connection with geological and geophysical exploration within the United States may be amortized ratably over a 24-month period. Major integrated oil companies must use amortization over a 5-year period.

6. The **Energy Tax Incentives Act of 2005** extended the carryback period to five years with respect to a portion of the NOLs of certain electric utility companies arising in taxable years ending in 2003, 2004, and 2005. IRC § 172(b)(1)(I).

7. The **Energy Tax Incentives Act of 2005** added two new components to the energy credit: (1) a credit equal to 30 percent of the cost of "qualified fuel cell property," and (2) a credit equal to 10 percent of the cost of "qualified microturbine property." The new components of the credit are available only for property placed in service in 2006 or 2007. In addition, the Act increases the credit rate to 30 percent for solar energy property, for 2006 and 2007. Also for only those two years, the Act provides a 30 percent credit for the cost of fiber-optic solar lighting systems.

8. A credit under § 45 is allowed under the **Energy Tax Incentives Act of 2005** for the production of "Indian coal," defined as coal produced from reserves which were owned by (or held in trust by the United States for the benefit of) an Indian tribe or its members on June 14, 2005. To qualify for the credit, the coal must be produced by a facility placed in service before January 1, 2009. The credit is available for coal produced during the years 2006 through 2012, and sold by the taxpayer to unrelated persons during the same time frame. The credit amount is $1.50 per ton of Indian coal during the years 2006 through 2009, and $2.00 per ton thereafter.

9. The **Energy Tax Incentives Act of 2005** redesignated § 29 as § 45K, and made it part of the general business credit. It also added a credit for qualified facilities producing coke or coke gas. A qualified facility must have been placed in service before 1993, or after June 30, 1998, and before January 1, 2010. The credit amount is $3.00 (adjusted for post-2004 inflation) per barrel-of-oil equivalent, subject to a ceiling of an average barrel-of-oil equivalent of 4,000 barrels per day. With respect to production from a particular facility, the credit is available only for the four-year period beginning on the later of January 1, 2006, or the date the facility is placed in service.

10. The **Energy Tax Incentives Act of 2005** added a third credit to the § 40A mix, the "small agri-biodiesel credit." The credit equals 10 cents per gallon of qualified agri-biodiesel production (which is limited to 15 million gallons per year). It is available only to producers with an annual productive capacity of no more than 60 million gallons. The 2005 Act also provides that "renewable diesel" is treated in the same manner as biodiesel for purposes of the BMC and the BC, except that the credit amount is increased to $1.00 per gallon. Renewable diesel is defined as diesel fuel derived from biomass using a thermal depolymerization process. All credits under § 40A are scheduled to expire at the end of 2008.

11. **Credit for production from advanced nuclear power facilities.** Section 45J, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit of 1.8 cents per kilowatt-hour of electricity produced at a qualifying advanced nuclear power facility during the eight-year period beginning on the date the facility is placed in service. For a facility to qualify, the taxpayer must have received an allocation of megawatt capacity from the IRS and the facility must have been placed in service before January 1, 2021. If the megawatt allocation to the facility by the IRS is less than the facility's rated nameplate capacity, the otherwise allowable credit per kilowatt hour produced by the facility is proportionately reduced. For example, if the megawatt allocation were one-third of the rated nameplate capacity, the credit would be 0.6 cents per kilowatt hour. A taxpayer's annual credit during the eight-year period may not exceed $125 million per 1,000 megawatts of allocated capacity. Thus, for example, the credit ceiling for a taxpayer with 200 megawatts of allocated capacity would be $25 million.

12. **Credits for investments in clean coal facilities.** The **Energy Tax Incentives Act of 2005** introduced two new credits for investments in clean coal facilities.

Section 48A provides a credit for investments in "qualifying advanced coal projects," defined as projects using integrated gasification combined cycle (IGCC) and other advanced coal-based technologies for generating electricity. The credit rate is 20 percent of qualifying investments for IGCC projects, and 15 percent for other projects. The credit is available only for projects certified by the IRS, following consultation with the Energy Department. Aggregate credits allowed for certified projects may not exceed $800 million for IGCC projects, and $500 million for other projects. Section 48B provides a 20 percent credit for investments in "qualifying gasification projects," defined as projects involving the conversion of coal, petroleum residue, biomass, or certain other materials into a synthesis gas composed primarily of carbon monoxide and hydrogen. Like its companion credit, this credit is available only for projects certified by the IRS, in consultation with the Department of Energy. Total credits allocable by the IRS are limited to $350 million, of which no more than $130 million may be allocated to any single gasification project.

13. **SECOND: New energy efficient home credit.** Section 45L, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit, in the amount of either $2,000 or $1,000, to an eligible contractor (including the producer of a manufactured home) who constructs and sells an energy efficient home to a person who will use the home as a residence. To qualify for the $2,000 credit, the home must be certified (in accordance with guidance to be prescribed by the Treasury Department) as having a level of annual heating and cooling energy consumption at least 50 percent below the level of a comparable hypothetical reference dwelling unit, with at least one-fifth of the energy savings attributable to the building envelope. The $1,000 credit, which applies only to manufactured homes, requires at least a 30 percent reduction in energy consumption, of which at least one-third must be attributable to the building envelope. Manufactured homes are also eligible for the $2,000 credit, if they satisfy the usual requirements for that credit. The credit is available only with respect to homes the construction of which is substantially completed after 2005, and which are purchased during 2006 or 2007. The credit is part of the general business credit.

- Effective for homes substantially completed after 8/08/05 and sold after 12/31/05 but before 1/01/08).

a. **Procedures for getting the home certified.** Notice 2006-27, 2006-11 I.R.B. 626 (2/22/06). Procedures that an eligible contractor may follow to certify that a dwelling unit, other than a manufactured home, is an energy efficient home that satisfies the requirements of § 45L(c)(1). Certification must be performed by RESNET or an equivalent energy rating network. RESNET's website is located at http://www.natresnet.org.

b. Notice 2006-28, 2006-11 I.R.B. 628. Procedures that an eligible contractor may follow to certify that a dwelling unit that is manufactured home satisfies the requirements of § 45L(c)(2) and (3).

14. **Energy efficient appliance credit.** Section 45M, added to the Code by the **Energy Tax Incentives Act of 2005,** provides a credit to the manufacturer of certain energy efficient dishwashers, clothes washers, and refrigerators. The credit applies only to appliances produced in 2006 and 2007. In the case of dishwashers, the credit is available only for dishwashers satisfying the (not yet known) Energy Star standards for 2007. The per-dishwasher credit amount is the product of $3 and the percentage by which the 2007 standards exceed the 2005 standards, subject to a $100 ceiling. In the case of clothes washers, the credit amount is $100 for each washer manufactured in 2006 or 2007 which meets the 2007 Energy Star

standards. For refrigerators, the credit amount rules are rather complex: $75 for a refrigerator manufactured in 2006 and exceeding 2001 energy conservation standards by at least 15 percent, $125 for a refrigerator manufactured in 2006 or 2007 and exceeding 2001 standards by at least 20 percent, and $125 for a refrigerator manufactured in either year and exceeding 2001 standards by at least 25 percent. The credit applies only to appliances which constitute "excess production," which is defined as the excess of the number of appliances produced by the taxpayer in the United States during the calendar year (2006 or 2007) over the taxpayer's average production during the preceding three years (or over 110 percent of the average production over the preceding three years, in the case of refrigerators). The total amount of credits a taxpayer may claim under § 45M, for the two years combined, is limited to $75 million, and the credit allowed in any one year may not exceed 2 percent of the taxpayer's annual average gross receipts for the three preceding taxable years. The credit is part of the general business credit.

15. **THIRD: Highlights of the new alternative motor vehicle credits:** Prior to 2006, the primary tax incentive for purchasing a new qualifying clean-fuel vehicle weighing 10,000 pounds or less (including hybrid-electric vehicles) is the maximum **$2,000** above-the-line deduction allowed for the additional costs of producing the vehicle to run on a clean-burning fuel. The maximum deduction allowed for the additional costs of producing the vehicle to run on a clean-burning fuel is **$5,000** for trucks or vans weighing from 10,000 to 26,000 pounds and **$50,000** for trucks or vans weighing over 26,000 pounds and for certain buses.

- For qualifying vehicles placed-in-service after December 31, 2005, the Energy Act eliminates the clean-burning fuel deduction, replacing it with four new separate and more generous tax credits: **a)** the hybrid motor vehicle credit, **b)** the advanced lean burn technology motor vehicle credit, **c)** the fuel cell motor vehicle credit, **and d)** the alternative fuel motor vehicle credit. Of these, the hybrid credit is the only one now available.

- **Common Requirements.** Although each of these four credits must satisfy its own separate criteria, they all have the following common requirements and features: **a)** the manufactured vehicle must not be used predominantly outside the U.S., **b)** the original use must start with the taxpayer, **c)** taxpayer can not acquire the vehicle for resale (although the vehicle may be leased to another party), **d)** if the vehicle is used for business, the credit will be treated as a "general business credit," **e)** the credits are not allowed to reduce the alternative minimum tax, **f)** the credits **allowed** reduce the basis of the vehicle, however, a taxpayer may elect not to take the credit, **g)** although buyers typically take the credit, someone who sells the new vehicle to a tax-exempt organization or governmental entity may be entitled to the credit (§ 30B(h)(6)), **h)** a "motor vehicle" includes any vehicle manufactured primarily for use on public streets, roads, and highways, and has at least four wheels, **i)** IRS is authorized to release rules providing for recapture of the credits if the qualified vehicle ceases to meet the requirements for the credit (including recapture in the case of a lease period of less than the economic life of the vehicle), and **j)** the credit is not available for the cost of the vehicle that is deducted under § 179.

- **Alternative motor vehicle credit.** Section 30B, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit for certain "alternative motor vehicles." The credit is available in the year a qualifying vehicle is placed in service–for either business or personal use–by the taxpayer. The credit is generally allowed to the owner of the vehicle, including the lessor of a vehicle subject to a lease. If a vehicle is sold to a tax exempt user, the person who sold the vehicle to the user may claim the credit, but only if the seller clearly discloses the amount of the credit to the user. IRC § 30B(h)(6). A taxpayer claiming the credit must reduce his basis in the vehicle by the amount of the credit.

- A new qualified hybrid motor vehicle is a vehicle, the original use of which commences with the taxpayer, which uses both an internal combustion engine and a rechargeable battery system, which meets specified emission standards, and which meets specified minimum standards for maximum available power. For cars and light trucks, the credit amount is the sum of the fuel economy component and the conservation component, determined under the same rules applicable to lean burn vehicles. For other vehicles, the credit is a percentage of the excess of the manufacturer's suggested retail price (MSRP) for the vehicle over the MSRP of a comparable non-hybrid vehicle–20 percent if the vehicle achieves at least a 20 percent increase in city fuel economy relative to a comparable non-hybrid vehicle, 30 percent for an increase of at least 40 percent, and 40 percent for an increase of at least 50 percent. Section 30B(d) is effective for property placed in service after 12/31/05 and generally before 1/01/10. Hybrid vehicles are the only *green* vehicles currently being mass produced.[1] The new hybrid motor vehicle credit applies, in differing amounts, to passenger automobiles and light trucks, and other hybrid motor vehicles.

- <u>Credit Amount for Passenger Vehicles or Light Trucks With GVWs of No More than 8,500 Lbs.</u> The total credit for these hybrid vehicles with gross vehicle weights (GVWs) of no more than 8,500 lbs is the sum of a two-part credit amounts: i) the "fuel economy credit amount" and ii) the "conservation credit amount."

- <u>Fuel Economy Credit Amount.</u> This component of the credit depends upon the fuel economy of the vehicle expressed as a percentage of the 2002 model year city fuel economy (2002 MYCFE). The 2002 MYCFE for a vehicle is between $400 and $2,400, determined on a miles-per-gallon basis as determined by the EPA using the tables provided in §30B(b)(2)(B).

- <u>Additional Conservation Credit Amount.</u> The credit for a new hybrid motor vehicle as determined under the rules above is increased by a conservation credit amount of between $250 and $1,000 based on the vehicle's "lifetime fuel savings."

- <u>Note!</u> There are several leading car manufacturers that already have an established market for their qualified hybrid vehicles. These manufacturers could possibly reach the 60,000 vehicle limit in 2006. <u>For example,</u> it is reported that Toyota sold over 50,000 of its popular Prius hybrids in the first 6 months of 2005, expects to sell 100,000 by the end of this year, and anticipates they will sell at an even faster pace in 2006. Honda and Ford Motor Company also have hybrids on the market, but in smaller numbers. This "60,000 limit" may benefit domestic auto makers that are planning to come on line with their first hybrids in 2006, 2007, or 2008.

- <u>Planning.</u> Before buying a hybrid vehicle in 2006 or later years, a client should check with the manufacturer to determine whether the credit is still available for that manufacturer's hybrids. You should also have the manufacturer confirm the amount of the credit. It is expected that the IRS will be announcing the official credit amounts for each model of qualifying hybrid.

a. **IRS Releases Notice 2006-9 Providing Guidance on the Qualified Hybrid Tax Credit.** Notice 2006-9, 2006-6 I.R.B. 413 (2/6/06). This notice sets forth interim guidance, pending the issuance of regulations, relating to the new advanced lean burn

[1] But see manufacturers' web sites for other available colors.

technology motor vehicle credit under § 30B(a)(2) and (c) of the Internal Revenue Code and the new qualified hybrid motor vehicle credit under § 30B(a)(3) and (d).

b. IR-2006-56 (4/7/06). IRS acknowledges the certification by Ford of certain models of the Ford Escape and Mercury Mariner hybrids for credit amounts between $1,950 and $2,600.

c. IR-2006-57 (4/7/06). IRS acknowledges the certification by Toyota of certain models of the Toyota Prius, the Toyota Highlander, and the Lexus RX400h for credit amounts between $2,200 and $3,150.

d. **Let no good deed go unpunished.** IR-2006-112 (7/13/06). Employer incentives in the form of cash rebates to employees who purchase environmentally friendly hybrid vehicles are to be included in the employees' income as compensation.

16. **Alternative fuel vehicle refueling property credit.** Section 30C, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a credit equal to 30 percent of the cost of any qualified alternative fuel vehicle refueling property placed in service by the taxpayer. Qualifying fuels are ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and mixtures of diesel and biodiesel containing at least 20 percent biodiesel. For a business taxpayer, the credit may not exceed $30,000. The credit is also available to a taxpayer installing a refueling facility on the grounds of his personal residence for personal use, but the maximum amount of the nonbusiness credit is $1,000. The business credit is part of the general business credit, and the personal credit is allowed only to the extent of the excess of the regular tax (reduced by certain other credits) over the tentative minimum tax. The credit is not available for property placed in service after 2009 (or after 2014, in the case of property relating to hydrogen).

17. **FOURTH: Nonbusiness energy property credit. Certification is obtained by the manufacturer.** Section 25C, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a nonrefundable credit for certain expenditures to improve the energy efficiency of a taxpayer's principal residence. In the case of "qualified energy efficiency improvements" (QEEIs), the credit equals 10 percent of the cost of the improvements. A QEEI is any energy efficient building component (i.e., insulation, exterior windows and doors, and certain coated metal roofs) satisfying criteria established by the 2000 International Energy Conservation Code, if the original use of the component commences with the taxpayer and the component is expected to remain in use for at least five years. The other category of credit-eligible costs is "residential energy property expenditures" (REPEs). REPEs are expenditures for the following types of property, if they are installed in the taxpayer's principal residence and satisfy energy efficiency standards to be promulgated by the Secretary of the Treasury pursuant to detailed statutory instructions: (1) main air circulating fans, (2) natural gas, propane or oil furnace or hot water boilers, and (3) "energy efficient building properties" (electric heat pump water heaters, electric heat pumps, geothermal heat pumps, central air conditioners, and water heaters using natural gas, propane, or oil). For REPEs the credit amount is established by schedule: the first $50 of the cost of a main air circulating fan, the first $150 of the cost of a natural gas, propane, or oil furnace or hot water boiler, and the first $300 of the cost of any item of energy-efficient building property. There is a lifetime limit of $500 on the aggregate credits a taxpayer may claim under § 25C, of which no more than $200 may be based on expenditures for windows. The credit is available only for property placed in service in 2006 or 2007.

a. **Certification to be obtained from manufacturer.** Notice 2006-26, 2006-I.R.B. 222 (2/22/06). Pending the issuance of regulations, this notice provides procedures that manufacturers may follow to certify property as either an "eligible building envelope component" or "qualified energy property," and guidance regarding the conditions under which taxpayers seeking to claim the § 25C credit may rely on a manufacturer's certification (or, in the case of certain windows, an "Energy Star" label).

18. **FIFTH: Credit for residential energy efficient property, e.g., solar panels.** Section 25D, added to the Code by the **Energy Tax Incentives Act of 2005**, provides a nonrefundable credit for certain expenditures on residential energy efficient property. Qualifying property is of three types: photovoltaic property (which uses solar energy to generate electricity), solar water heating property, and fuel cell property (which converts a fuel into electricity using electrochemical means). The property must be installed in a dwelling unit located in the United States and used by the taxpayer as a residence (principal residence, in the case of fuel cell property). Expenditures allocable to a swimming pool or hot tub are not eligible for the credit. The credit equals 30 percent of qualifying expenditures, subject to annual ceilings (on the credit amounts, not on credit-eligible expenditures) of $2,000 for photovoltaic property, $2,000 for solar water heating property, and $500 per half kilowatt of capacity of fuel cell property. The credit is available only for property placed in service in 2006 or 2007.

19. **TIPRA** § 503 adds new § 167(h)(5) to increase the amortization period for G&G expenditures of major integrated oil companies from 24 months to 5 years, effective for amounts paid or incurred after 5/17/06.

H. Loss Transactions, Bad Debts and NOLs

1. Jefferson Smurfit Corp. v. United States, 439 F3d 448 (8th Cir. 3/6/06), *rehearing denied*, 2006 U.S. App. LEXIS 13606 (6/1/06). Judge Murphy held that a tentative NOL carryback allowed under § 6411 is subject to adjustment after the subsequent audit of year in which the NOL arose – even if the Tax Court has issued a final order determining the taxpayer's liability for the carryback year.

I. At-Risk and Passive Activity Losses

1. Rev. Rul. 2005-64, 2005-39 I.R.B. 600. If the owner of an aircraft leases it to others for transportation but provides the services of the pilot and crew with the aircraft, the use of the aircraft by the lessee is incidental to its receipt of the extraordinary personal services provided the lessor, and the activity therefore is not a rental activity for purposes of § 469; if the owner of the aircraft does not provides the services of the pilot and crew the activity is a rental activity for purposes of § 469.

2. D'Avanzo v. United States, 67 Fed. Cl. 39 (7/26/05), *appeal dismissed*, 2006 U.S. App. LEXIS 4545 (Fed. Cir. 2/14/06). Taxpayer did not offer a contemporaneous written record of the number of hours he spent performing personal services with respect to rental properties; noncontemporaneous log book of hours claimed to have been devoted to real estate activities and testimony at trial, alone, are inadequate evidence to establish that taxpayer devoted requisite number of hours to real estate business activities.

3. **Beware conversions of one type of entity into another because they may have tax ramifications.** Hubert Enterprises, Inc. v. Commissioner, 125 T.C. No. 6 (9/21/05). A member of a limited liability company (LLC) taxed as a partnership is not at-risk for any amount borrowed by the LLC with full recourse against the LLC because under relevant state law LLC members were not liable for LLC's debts and the member did not guarantee the debt.

• The aggregation of § 1245 property leasing activities of a partnership under § 465(c)(2)(B)(i) applies only to leases in which the property is placed in service in the same year; activities involving leased property placed in service in different years may not be aggregated.

4. Ramsburg v. Commissioner, T.C. Memo. 2005-252 (10/31/05). Section 469(g)(1) does not apply to permit deduction of suspended passive activity losses following the distribution by the partnership to taxpayer-partner [in a tax-free distribution under § 731] of assets used by partnership in an activity with respect to which the taxpayer-partner was passive.

III. INVESTMENT GAIN

A. Capital Gain and Loss

1. **House sales by transferred employees.** Rev. Rul. 2005-74, 2005-51 I.R.B. 1153 (11/30/05). This Ruling sets forth three situations relating to whether a transferred employee sold his home to his employer (via the relocation company retained by the employer), or whether he sold it to a third party. The first two were held to be a sale to the employer, either pursuant to an appraisal (Situation 1) or an appraisal with an "amended value option" that increases the sale price if a third-party buyer makes a higher offer (Situation 2). The third was held to be a sale to a third party buyer, where the relocation company merely pays the employee the value of his equity based on the higher amended value only if the sale to the third party buyer closes (Situation 3). (applying transfer of benefits and burdens of ownership analysis to various structures of employer sponsored relocation programs involving the purchase of the employee's home by the employer through the employer's agent or to a third party facilitated by the employer's agent; execution of blank deed by employee and delivery to employer's agent company may be consistent with, but does not necessarily evidence, closed sale; price adjustment contingent on management relocation company receiving a bona fide third offer at a higher price subsequent to closing with employee does not necessarily mean benefits and burdens of ownership have not passed; price adjustment contingent on management relocation company entering into contract to resell at a higher price subsequent to closing with employee indicates that benefits and burdens of ownership have not passed).

• Query whether the employee has income because he apparently pays no brokers' commissions on the sale of his house.

2. **Questioning the collar.** Technical Advice Memorandum 200604033 (10/20/05), first discussed in a David Cay Johnston story in the New York Times, 12/30/05.The story discusses a then-unreleased TAM that says that a loan of shares subject to a prepaid variable forward results in a sale for tax purposes because the agreement provided that the shares that were the subject of the forward contract would be lent to the forward contract counterparty. The TAM also provided that § 1058, which provides for the nonrecognition of gain in some securities lending transactions, does not apply because the taxpayer had given up all indicia of ownership, including most risk of loss and opportunity for gain. The TAM distinguished the transaction at issue from the type permitted under Rev. Rul. 2003-7.

a. **This collar just plain clean works.** Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (1/16/03). The IRS rules that a shareholder has neither sold stock currently nor caused a constructive sale of stock under § 1259 where he (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date [but which does provide a "collar" on the number of shares of stock to be delivered, in effect providing a "collar" on the ultimate sale price], (3) pledges the maximum number of shares for which delivery could be required, (4) has the unrestricted right to deliver the pledged shares or to substitute cash or other shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares.

- There was not a sale of the pledged shares because the shareholder was not required to relinquish the pledged shares but had an unrestricted right to reacquire them by delivering cash or other shares. There was not a constructive sale under § 1259(c)(1)(C) because due to the variation in the number of shares that might be delivered, the agreement was not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1).

3. **IRS backs down on its effort to have tax return preparers enter all securities sales transactions on Schedule D or Schedule D-1. How will it obtain verifiable basis records?** On 1/9/06, the IRS published on its web site the following Notice of Clarification of the 2005 Instructions for Schedule D (Form 1040):

> The IRS has received many inquiries about a new instruction that was added on page D-6 of the 2005 Schedule D instructions for completing lines 1 and 8. The new instruction states:
>
> > You must enter the details of each transaction on a separate line. If you have more than five transactions to report on line 1 or line 8, report the additional transactions on Schedule D-1. Use as many Schedules D-1 as you need. Enter on Schedule D, lines 2 and 9, the combined totals from all your Schedules D-1. Do not enter "see attached" and summary totals from an attachment in lieu of reporting the details of each transaction directly on Schedule D or D-1.
>
> The new instructions on page D-6 were meant to highlight and clarify [the existing] rules, not to change them. Therefore, taxpayers may continue to use a substitute statement to provide all of the same information and in a similar format to lines 1 and 8 of Schedules D and D-1. They are not required to use the official version of Schedules D and D-1 to provide the details on each transaction. However, the details of each transaction still must be provided with the tax return and not just upon request.

a. One of the inquiries was a 12/23/05 letter from the Chair of the AICPA Tax Executive Committee, which stated that tax-return preparers traditionally reported the summary totals found on year-end brokerage statements directly onto the Schedule D, with a notation to "see attached" brokerage statements [for taxpayers who are involved with numerous security sales transaction during the course of the calendar year]. The letter noted that large corporations that use summary form procedures may state on their return that transactional data details will be made available upon request.

4. **The Third Circuit devised a new test for determining whether the sale of a right to an income stream produced capital gain or ordinary income.** Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2/14/06). The taxpayer sold all of his rights to all of the remaining payments under a winning lottery ticket. The court rejected the "substitute for ordinary income" analysis as over-broad, and instead devised a test related to the "family resemblance" of a particular transaction to traditional capital assets analysis. The family resemblance test was

based on the (1) "type of 'carve out'" – horizontal versus vertical – and the (2) "character of asset" involved. The court reasoned that "because a vertical carve-out could signal either capital-gains or ordinary-income treatment, ... when we see a vertical carve-out, we proceed to the second factor – character of the asset – to determine whether the sale proceeds should be taxed as ordinary income or capital gain."

- Under the character of the asset analysis, assets that constitute a right to earn income from the property accrued in the future merit capital-gains treatment, while assets that are a right to receive income accrued in the past merit ordinary-income treatment. Applying this analytical model the court concluded, "because a right to lottery payments is a right to earned income (i.e., the payments will keep arriving due simply to ownership of the asset), the lump-sum payment received by the Latteras should receive ordinary-income treatment." Note that under this test, the taxpayer in *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), would continue to be entitled to capital gains treatment on the sale of a life estate, because the income therefrom would not yet have accrued at the time of the sale.

- Other courts of appeals that have addressed the issue likewise have held that the proceeds form the sale of lottery proceeds are ordinary income, not capital gains, although the reasoning of the different courts varies.

a. **Lottery winners' sale of rights to lottery installments results in ordinary income under the substitute-for-ordinary-income doctrine.** Watkins v. Commissioner, 447 F.3d 1267 (10th Cir. 5/10/06). The court followed earlier lottery assignment cases in so holding, including *United States v. Maginnis*, 356 F.3d 1179(9th Cir. 2004), and *Davis v. Commissioner*, 119 T.C. 1 (2002). Particularly, the court followed the reasoning in *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958), which held that the "substance of what was assigned was the right to receive future income" and the "substance of what was received was the present value of income which the recipient would otherwise obtain in the future" and "consideration was [not] paid for an increase in the value of the income-producing property."

- The court held that the proceeds were ordinary income under the "substitute-for-ordinary-income doctrine," while "refus[ing] to enter the fray" regarding whether the analysis under *Maginnis* or that under *Lattera* should be applied, and declining to "formulate any specific test regarding the doctrine's application"

b. Wolman v. Commissioner, 2006 WL 1376899 (10th Cir. 5/19/06), followed *Watkins*.

5. **Capital gain treatment for sales of self-created musical works. TIPRA** § 204 adds new § 1221(b)(3) to permit taxpayers to elect to treat the sale or exchange of self-created musical compositions or copyrights in musical works sold or exchanged after 12/31/06 and before 1/1/11 as the sale or exchange of a capital asset. This capital asset treatment is to be inapplicable for § 170(e) purposes, so the amount of the charitable deduction of such assets continues to be reduced by the amount of appreciation inherent in such assets. Section 1221(b)(3), added to the Code in 2006, permits a taxpayer to elect to treat a self-created musical work as a capital asset, if the taxpayer sells or exchanges the work before 2011. For § 1221(b)(3), see ¶31.06, this supplement. The 2006 legislation, however, also amended §170(e)(1)(A) to provide that new §1221(b)(3) is not taken into account in determining the amount of any charitable deduction for the donation of a self-created musical work.

6. REG-109367-06, Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable, 71 F.R. 44600 (8/7/06). Proposed regulations to clarify when accounts or

notes receivable are acquired in payment for inventory or services rendered within the meaning of § 1221(a)(4), which has the effect of permitting loss on the sale or exchange of such accounts or notes receivable to be ordinary. These regulations would exclude situations where the accounts or notes receivable are acquired for consideration other than § 1221(a)(1) property or services.

7. Merlo v. Commissioner, 126 TC No. 10 (4/25/06). The Tax Court (Judge Haines) held that limitations on capital losses under §§ 1211 and 1212 apply for purposes of calculating alternative minimum taxable income. Thus, capital losses realized in 2001 upon worthlessness of stock acquired pursuant to the exercise of incentive stock options did not create an AMT NOL that could be carried back to reduce AMTI in 2000 [the year of exercise].

B. Interest

1. **Interest-free loans to continuing care facilities may be without limit through 2010. TIPRA** § 209 adds new § 7872(h), which removes the $100,000 dollar cap for excepting interest-free loans to continuing care facilities from imputed interest rules for years through 2010. It also reduces the minimum age of qualifying lenders from 65 to 62.

C. Section 1031

1. **While all "exchanges of real property interests are not, ipso facto, like-kind exchanges under section 1031," this taxpayer's exchange was.** Peabody Natural Resource Co. v. Commissioner, 126 T.C. No. 14 (5/8/06). The Tax Court (Judge Gerber) held that receipt of coal mining property and appurtenant coal supply contracts with electric utility companies in exchange for gold mining property without supply contracts was a § 1031 exchange without boot. The coal supply contracts were not separate intangible property. The Tax Court articulated the standard to be applied in deciding whether real property interests are considered to be like-kind as follows.

> To decide whether an exchange is like kind within the meaning of section 1031(a), we must compare the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. ... In making this comparison, consideration is to be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.

- For example, under this standard, rights appurtenant to land, such as leases and mineral supply contracts, are part of the bundle of rights incident to ownership of the land that are not separate property interests but merely constitute a distinction in the grade or quality of the old and new mining properties.

D. Section 1033

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. **Guidance on Health Savings Accounts.** Notice 2004-2, 2004-2 I.R.B. 269 (12/22/03). The IRS has issued guidance in Q&A form on Health Savings Accounts under new § 223 (added by § 1201 of the **Medicare Prescription Drug Improvement, and Modernization Act of 2003**). This guidance provides basic information about HSAs. This new provision offers health spending accounts without the "use it or lose it" requirement of health FSAs.

a. REG-138647-04, Employer Comparable Contributions to Health Savings Accounts Under Section 4980G, 70 F.R. 50233 (8/26/05). Proposed regulations to provide guidance on employer comparable contribution to HSAs under § 4980G, which provides an excise tax on the failure of an employer to make "comparable contributions" to the HSAs of all comparable participating employees [employees in the same category of "self-only" or "family"] when it makes a contribution to any employee's HSA.

b. **Final regulations in Q&A form.** T.D. 9277, Employer Comparable Contributions to Health Savings Accounts Under Section 4980G, 71 FR 43056 (7/28/06). Final regulations provide guidance on how to interpret the comparable contribution rules that employers must follow if they contribute funds to an employee's health savings account.

2. Rev. Rul. 2005-60, 2005-37 I.R.B. (8/25/05). The employer subsidy for maintaining prescription drug coverage is not considered in computing the applicable employer cost when determining whether the minimum cost requirement of § 420(c)(3) is met with respect to transfer of the excess pension assets of a defined benefit plan to a health benefits account which is part of the plan.

3. **Domestic partner medical expense reimbursements are includible in the employee's income.** Rev. Rul. 2006-36, 2006-36 I.R.B. (8/14/06). Medical expense reimbursements made to employees for payments of the medical expenses of a beneficiary other than the employee's spouse or dependents are not excludable from gross income.

B. Qualified Deferred Compensation Plans

1. **"Mr. Gotbucks, meet Senator Roth."** REG-152354-04, Designated Roth Contributions to Cash or Deferred Arrangements Under Section 401(k), 70 F.R. 10062 (3/2/05). Proposed regulations relating to an election under § 402A that will be available beginning in 2006 for employees to designate contributions to a 401(k) plan made under a qualified cash-or-deferred arrangement as Roth contributions. These contributions will be currently includible in gross income but qualified distributions will be excludable from gross income.

a. **Final regulations on Roth contributions under qualified cash or deferred arrangements under § 401(k).** T.D. 9237, Cash or Deferred Arrangements, 71 F.R. 6 (1/3/06). These final regulations §§ 1.401(k)-1(f) and 1.401(k)-2(b) require a pre-tax alternative elective contribution to the Roth contribution. They also require an irrevocable designation to be made by the employee at the time of the cash or deferred election, and require that Roth contributions be maintained by the plan in a separate designated Roth account for the employee. Matching contribution will not be permitted to be allocated to a designated Roth account. Effective for taxable years beginning after 12/31/05.

- These final regulations retain the requirement that a designated Roth contribution must satisfy the requirements applicable to any other elective contributions made under a qualified cash or deferred arrangement. Thus, designated Roth contributions are subject to the nonforfeitability and distribution restrictions applicable to elective contributions and are taken into account under the actual deferral percentage test (ADP test) of § 401(k)(3) in the same manner as pre-tax elective contributions. Similarly, designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan.

2. **MRD requirements apply to designated Roth accounts in qualified plans, but not to amounts rolled over to Roth IRAs.** REG-146459-05, Designated Roth Accounts Under Section 402A, 71 F.R. 4320 (1/26/06). These proposed regulations provide

comprehensive guidance on the taxation of distributions from designated Roth accounts. There is no inclusion in income if the distribution is a qualified distribution, which is a distribution that is made after a 5-taxable-year period of participation and that is either made after the employee attains 59-1/2, made after the employee's death, or is attributable to the employee's being disabled. The 5-taxable-year period, during which a distribution is not a qualified distribution, begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have been completed. However, if a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

3. **How to implement what God hath Roth.** Notice 2006-44, 2006-20 I.R.B. (4/24/06). This notice contains a sample amendment to enable plan sponsors to provide for designated Roth contributions in their 401(k) plans.

4. Under the **Katrina Tax Act**, withdrawals of up to $100,000 from retirement plans made between 8/29/05 and 12/31/06 for relief relating to Hurricane Katrina would not be subject to the 10-percent premature withdrawal tax under § 72(t). This exception applies to withdrawals from IRAs as well.

5. Under the **Katrina Tax Act**, recontributions of withdrawals for home purchases cancelled due to Hurricane Katrina would be treated as rollovers if made before 3/1/06.

6. Under the **Katrina Tax Act**, loans of up to $100,000 from qualified plans made between 9/24/05 and 12/31/06 for relief relating to Hurricane Katrina will receive favorable treatment.

7. T.D. 9256, Revised Regulations Concerning Disclosure of Relative Values of Optional Forms of Benefit, 71 F.R. 14798-02 (3/24/06). Final regulations under § 417(a)(3) concerning the content requirements applicable to explanations of qualified joint and survivor annuities and qualified preretirement survivor annuities payable under retirement plans. These regulations provide that the explanation must disclose the relative value of any optional forms of benefit compared to the value of the QJSA if the actuarial present value of that optional form of benefit is less than that of the QJSA. Effective for explanations provided for annuity starting dates beginning on or after 2/1/06.

8. **Plan participants can now get some help on investing their 401(k) accounts. Pension Protection Act** § 601 amends ERISA § 408 and Code § 4975 to permit employers and plan trustees to provide investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of defined contribution plans who direct the investment of their accounts, by creating another exclusion from prohibited transaction treatment. Effective for advice provided after 12/31/06.

9. **Cash balance plan proposed regulations provide a green light for adoptions of cash balance plans favoring younger employees, including permission to require quasi-geriatrics to spin their [retirement accrual] wheels during "wear-away" periods.** REG-209500-86 and REG-164464-02, Reductions of Accruals and Allocations Because of the Attainment of any Age; Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans, 67 F.R. 76123 (12/11/02). These proposed regulations provide guidance on age discrimination requirements under §§ 411(b)(1)(H) and 411(b)(2), including the allocation of

these requirements to cash balance pension plans.

- A cash balance plan is a defined benefit plan under which an employee has a hypothetical individual account that provides a benefit upon retirement based upon pay credits and interest credits – a concept that closely resembles a defined contribution plan. Section 411(b)(1)(H) provides that a defined benefit plan fails to comply with the age discrimination rules of § 411(b) if benefit accrual is ceased or reduced on the attainment of any age, and § 411(b)(2) provides that a defined contribution plan similarly fails to comply unless the rate at which amounts are allocated to an employee's account is not similarly ceased or reduced because of age.

- A cash balance qualifies, *inter alia*, only if "the participant accrues the right to future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age."

- The rules for conversion of traditional defined benefit plans to cash balance plans require that either (1) the converted plan defines the benefit as the sum of the benefits under the traditional defined benefit plan and the cash balance account, or (2) the converted plan must establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit. The second alternative would permit a "wear-away" period during which the participant will not accrue net benefits for some period after the conversion.

a. **Treasury and IRS withdraw the proposed cash-balance plan nondiscrimination regulations.** Announcement 2003-22, 2003-17 I.R.B. 846 (4/7/03). The proposed nondiscrimination regulations under § 401(a)(4) that would have required a modified form of cross-testing, which were proposed at the same time as the proposed cash balance regulations, are withdrawn because (as proposed) they would make it difficult "for plan sponsors converting long-standing traditional pension plans to cash balance plans to provide different types of transitional relief to plan participants." The announcement states that the withdrawn proposed regulations will be re-proposed.

b. Section 205 of the **Consolidated Appropriations Act, 2004,** Pub. L. 108-199 (enacted 1/23/04), provided that none of the funds made available in the appropriations act could be used to issue any rule or regulation that implemented the proposed age-discrimination regulations or any regulations reaching similar results.

c. **Proposed cash balance plan regulations are completely withdrawn.** Announcement 2004-57; 2004-27 I.R.B. 15 (6/15/04). The December 2002 proposed regulations were withdrawn in order to give Congress the opportunity to consider the administration's legislative proposal and to address cash balance plan issues through legislation.

d. **District court finds that IBM cash balance plan violates ERISA – but case is reversed after Congress passes the Pension Protection Act of 2006.** Cooper v. IBM Personal Pension Plan, 274 F. Supp. 2d 1010 (S.D. Ill. 7/31/03). Plan violates ERISA §§ 204(b)(1)(G) [reduction of accrued benefit solely on increases in age or service] and 204(b)(1)(H) [rate of benefit accrual decreases once a certain age is attained].

e. **Seventh Circuit reverses IBM case, but only after Congress acts to legalize cash balance plans.** Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir. 8/7/06), *rehearing denied*, 2006 U.S. App. LEXIS 23227 (7th Cir. 9/1/06). *rev'g* 274 F. Supp. 2d 1010 (S.D. Ill. 7/31/03). The Seventh Circuit (Judge Easterbrook) analyzes the situation by comparing ERISA § 204(b)(1)(H) [the anti-age discrimination provision applicable to defined benefit plans] with ERISA § 204(b)(2)(A) [the anti-age discrimination provision applicable to defined contribution plans]. He makes the point that "benefit accrual" in § 204(b)(1)(H) does not have the same meaning as "accrued benefit," which is defined in ERISA § 3(23)(A) as an amount "expressed in the form of an annual benefit commencing at normal retirement age."

- He ascribes to the district court its conclusion that cash balance plans discriminate on account of age based on an example comparing the benefit received by a 30-year-old who leaves IBM at age 50 with the benefit received by a 45-year-old who retires at age 65, and states that the district court based its conclusion of discrimination on the fact that the difference in accrued benefit at age 65 – attributable to 15 additional years of compound interest – is not counterbalanced by the fact that older workers generally draw higher salaries. Judge Easterbrook rejects this interpretation of the statute that "treats the time value of money as age discrimination."

- He reinforces this conclusion by noting it is identical to the view of the Treasury Department expressed in the December 2002 proposed regulations which concluded that the proper question to ask is, "if this employee were younger, would the hypothetical balance have grown more this year?"

f. **The world is now safe for cash balance plans. Pension Protection Act** § 701 amends ERISA §§ 203, 204 and 205, Code §§ 411 and 417, and ADEA § 4(i)(2) to provide that cash balance plans do not per se violate the prohibition on age discrimination.

10. **The increased funding limits provided in the 2001 Act are made permanent. Pension Protection Act** § 811 repeals the sunset provision of EGTRRA as applied to the provisions relating to pensions and IRAs.

11. **Pension Protection Act** § 812 makes the Code § 25B saver's credit permanent.

12. **Nonspouse plan beneficiaries can receive the same treatment as nonspouse IRA beneficiaries. Pension Protection Act** § 829 adds new Code § 402(c)(11) to permit nonspouse beneficiaries to roll their benefits over to an "inherited IRA" which will be subject to the distribution rules applicable to beneficiaries, i.e., distributions over the life of the beneficiary under Code § 401(a)(9).

13. **Enron survivors get some "catchup" to go with their tea and sympathy. Pension Protection Act** § 831 amends Code § 219 to permit certain 401(k) plan bankruptcy survivors to make additional deductible "catchup" contributions to an IRA during the years 2007 to 2009 if transactions related to the bankruptcy led to an indictment or a conviction.

14. **Anti-cutback rules were not violated by plan amendments in accordance with statutory change [from PBGC rate to Treasury rate] in the applicable interest rate for the present value calculation of pension plan lump-sum payments to retirees.** Stepnowski v. Commissioner, 124 T.C. No. 12 (4/26/05). In this declaratory judgment case, Judge Cohen held that an amendment made by petitioner's employer, Hercules Incorporated, to its pension plan's lump-sum option did not violate the anti-cutback rule of § 411(d)(6). The amendment was made in 2001 during the GUST amendment period and permitted the plan sponsor to use the higher 30-year Treasury bond discount rate permitted under § 417(e)(3)(A) in computing the lump sum, as opposed to the lower PBGC rate that was required by that Code provision prior to its amendment by the Uruguay Round Agreements Act of 1994, Pub. L. 103-465.

a. **Affirmed**, 2006-2 U.S.T.C. ¶50, (3d Cir. 8/27/06). The Hercules plan was amended before the expiration of the deadline, as extended by the Commissioner, for making such amendments.

15. T.D. 9280, Section 411(d)(6) Protected Benefits, 71 F.R. 45379 (8/9/06). These final regulations provide guidance in the interaction between the § 411(d)(6) anti-cutback rules and the § 411(a) nonforfeitability requirements. Under these regulations, plan amendments that change the plan's vesting computation period do not violate § 411(d)(6) – even though amendments affecting vesting, accrued benefits or protected benefits do violate that provision.

C. Nonqualified Deferred Compensation, Section 83, and Stock Options

1. **Section 409A adds a new layer of rules for nonqualified deferred compensation.** Section 885 of the **Jobs Act of 2004** adds new § 409A which modifies the taxation of nonqualified deferred compensation plans for amounts deferred after 2004. Section 409A has changed the tax law governing nonqualified deferred compensation by making it more difficult to successfully avoid current inclusion in gross income of unfunded deferred compensation. Nevertheless, § 409A has not completely supplanted prior law. The fundamental principles of prior law continue in force but have been modified in certain respects.

a. **Section 409A guidance provides transition rules and excludes stock appreciation rights from the purview of that section.** Notice 2005-1, 2005-2 I.R.B. 274 (12/20/04). This notice provides in Q&A form guidance with respect to the application of § 409A. It answers a variety of interpretive questions regarding the application of § 409A by providing various definitions, including a definition of substantial risk of forfeiture, and guidance on the application of § 409A to various kinds of plans as well as to stock appreciation rights and arrangements between partners and partnerships. The notice provides that § 409A applies whenever a service provider is (a) an individual, (b) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (c) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. (Q&A-8) However, § 409A does not apply if both (a) the service provider is actively engaged in the trade or business of providing substantial services, other than as an employee or as a director of a corporation, *and* (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. (Q&A-8)

b. This notice reminded taxpayers that:

> although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

- A plan provides for deferral of compensation only if, "under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year." (Q&A-4.) Compensation is not treated as deferred compensation, however, if it is received after the last day of the service provider's taxable year pursuant to the service recipient's normal payroll period. (Q&A-4) Furthermore, compensation is not treated as deferred if it required to be paid and is actually or constructively received by the service provider by the later of: (i) the date 2 ½ months after the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the date 2 ½ months after the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

- Stock options, stock appreciation rights, and other equity-based compensation generally are considered to be deferred compensation subject to § 409A, unless certain specified conditions have been meet. (Q&A-4(d)). A nonstatutory stock option is not considered to be deferred compensation for purposes of § 409A if the following conditions have been met: (1) the exercise price may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the option is subject to taxation under § 83, and (3) the option does not include any deferred compensation feature other than deferred income recognition until the later of the exercise or disposition of the option. A stock appreciation right is not deferred compensation if the following conditions are met: (1) the value of the stock the excess over which the right provides for payment upon exercise may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock is traded on an established securities market, (3) only such stock may be delivered in settlement of the right, and (4) the right does not include any deferred compensation feature other than the deferral of recognition of income until the exercise of the right. (Q&A-4(d)).

- The notice provides the following standards regarding the existence of a substantial risk of forfeiture:

> Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. *** [A] condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

- In order to qualify under § 409A, a plan must require that distributions may be allowed only upon separation from service, disability, death, a specified time (or pursuant to a fixed schedule), change of control in a corporation (to be defined in regulations), occurrence of an unforeseeable emergency, or if the participant becomes disabled; distributions may not be allowed other than upon the permissible distribution events and the plan may not permit acceleration of a distribution except as provided in regulations. In the case of officers, directors and ten-percent shareholders of publicly-held corporations and to persons holding the same positions in non-publicly held corporations, distributions upon separation from service may not be made earlier than six months after the date of separation from service.
- The plan must provide that compensation for services performed during a taxable year may be deferred only if the election is made before the beginning of the year in which the services are performed (or, if contingent compensation, at least six months before the end of the year in which the services are performed).
- A plan may permit changes in the time and form of distribution, so-called "second [deferral] elections" will have to be made at least twelve months before the payment was to have been made, and must postpone the payment for at least five years from the date it otherwise would have been made. Additionally, offshore rabbi trusts are not permitted. Generally, any such subsequent election to extend the deferral must extend the first payment date by at least five years and cannot be made or take effect within twelve months of the due date of the first payment.
- Violations of these rules would make immediately taxable all amounts not subject to a substantial risk of forfeiture, plus interest at one percentage point above the underpayment rate plus additional tax of 20 percent of the amount improperly deferred.
- These new rules do not apply to nonqualified stock options, incentive stock options and employee stock purchase plans, but apparently do apply to stock appreciation rights.
- Benefits earned through the end of 2004 are grandfathered if the plan complied with prior law and it was not materially modified after 10/3/04.

c. **Proposed regulations incorporate much of the guidance in Notice 2005-1.** REG-158080-04, Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 F.R. 57930 (10/4/05). These proposed regulations incorporate much of the guidance provided in Notice 2005-1, as well as "substantial additional guidance." They identify the plans and arrangements covered by § 409A and describe the requirements for deferral elections and the permissible timing for deferred compensation payments. They also extend the deadline for "documentary compliance" to 12/31/06, but 1/1/05 remains as the effective date for statutory compliance (although there are transition rules applicable for 2005). See also Prop. Reg. §§ 1.409A-1 (definitions and covered arrangements); 1.409A-2 (deferral elections); 1.409A-3 (permissible payments); 1.409A-6 (statutory effective dates). The proposed regulations are proposed to be effective as of January 1, 2007. (defining unforeseeable emergency as: (1) a severe financial hardship resulting from an illness or accident of the service provider or the service provider's spouse or dependent (as defined in § 152(a)); (2) loss of property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by insurance, for example, not as a result of a natural disaster), or other similar extraordinary and unforeseeable circumstances arising as a result of uncontrollable events; (3) medical expenses; and (4) funeral expenses of a spouse or a dependent); Prop. Reg. § 1.409A-

1(i) (generally, a qualifying accelerated payment either (1) must be due on an objectively determinable date or according to an objectively determinable fixed schedule at the time the event occurs, or (2) must be within an objectively determinable calendar year following the year in which the event occurs; payment may be upon the earliest or latest of more than one qualified event). Prop. Reg. § 1.409A-3(h) (permitting acceleration in the event of a conflict of interest, to satisfy a qualified domestic relations order (QDRO), described in ¶36.09[5], main volume, pursuant to § 414(p)(1)(B), as a de minimis cash-out, or to pay FICA taxes.

d. **IRS allows almost two years to bring offshore rabbi trust assets home.** Notice 2006-33, 2006-15 I.R.B. 754 (3/21/06). This notice provides transition relief with respect to the application of § 409A(b) to provide that nonqualified plan assets remaining in offshore trusts on 3/21/06 will not trigger income inclusion if the plan conforms with the requirements of § 409A(b) by 12/31/07.

e. **Transition relief extended for NQDC under § 409A.** Notice 2006-79, 2006-43 I.R.B. (10/4/06). Although the IRS expects that the proposed regulations will become final by the end of 2006, the proposed effective date of 1/1/07 for the final § 409A regulations is extended to 1/1/08. Additional transition relief is provided through 12/31/07.

2. **Underfunded plan restricts NQDC for certain top employees. Pension Protection Act** § 116 adds new Code § 409A(b)(3) to provide that any assets set aside in a nonqualified deferred compensation arrangement for top employees [those covered by Code § 162(m)(3) or subject to § 16(a) of the Securities Exchange Act of 1934] will be currently taxable to them if the transfer is made during any period that the employer's defined benefit pension plan is in a so-called "at-risk status."

3. Palahnuk v United States, 70 Fed. Cl. 87, 97 AFTR2d 2006-1433 (2/28/06). The purchase of employer's stock pursuant to a nonstatutory stock option using funds obtained through borrowing on a margin account with a third party lender, [with the loan secured by the purchased stock] constituted a completed transfer for purposes of § 83; the arrangement was not in substance a continuing option under Reg. §§ 1.83-3(a)(2) and 1.83-1(a)(7), Ex. (2), because the benefits of ownership and risk of decline in value had been transferred to taxpayer.

a. Facq. v. Commissioner, T.C. Memo 2006-111 (5/23/06). This case reaches the same result under virtually identical facts.

4. Rev. Proc. 2006-31, 2006-27 I.R.B. 32. Procedures to request consent to the revocation of a § 83(b) election. Reg. § 1.83-2(f) permits a § 83(b) election to be revoked only with the consent of the Commissioner. Consent will be granted only where the election was made under a mistake of fact as to the underlying transaction. Valuation mistakes, decline in the property's value, and failure to satisfy conditions for the property vesting are not considered mistakes of fact. The failure of a service provider to understand the substantial risk of forfeiture associated with the transferred property or to understand the tax consequences of making a § 83(b) election is not a mistake of fact.

D. Individual Retirement Accounts

1. **The IRS issues regulations restricting conversions of traditional IRAs funded with annuities to Roth IRAs.** T.D. 9220, Temporary Regulation § 1.408A-4 (8/22/05). Taxpayers with modified adjusted gross income for a year that does not exceed $100,000 may convert a traditional IRA to a Roth IRA. However, upon the conversion, the amounts in the IRA that would be taxed if distributed are taxed in the year of the conversion. The IRS says that these

regulations were issued to curtail "springing" annuity contracts that artificially limit the amounts that must be included in a taxpayer's income upon conversion of a traditional IRA to a Roth IRA.

- In a news release announcing these temporary regulations, the Treasury Department said some IRA annuity products had been developed that treat the conversion amount as a temporarily reduced cash surrender value that would later "spring up" after the conversion to a more realistic value. Apparently, taxpayers argued that the amount taxed on the conversion of the traditional IRA to a Roth was the "depressed" cash surrender value. For example, IRS says some advisers market a transaction in which taxpayers are encouraged to invest their non-Roth IRA funds in a single premium annuity contract with significant artificial penalties that apply in the first year (or years) of the contract if the annuity is surrendered, causing the annuity to have a low cash surrender value in the early years of the contract. Under this transaction, shortly after the annuity contract is purchased by the non-Roth IRA, the taxpayer converts the IRA to a Roth IRA. In such a case, the taxpayer asserts that the only amount includible in gross income as a result of the conversion is the low cash surrender value. This assertion is made even though the surrender penalties are unlikely to be paid because the taxpayers do not expect to surrender the contract during the early years. In this case, the taxpayers expect that the ultimate payments under the contract will be qualified distributions from the Roth IRA (i.e., tax-exempt), and thus, they also expect the artificially depressed cash surrender value to be the only amount ever includible in gross income.

- <u>Regulations Require Taxation at FMV Not CSV.</u> The regulations specify that the full fair market value of the annuity must be included in income upon conversion of an IRA annuity to a Roth. The regulations require that fair market value is to be determined using Reg. § 25.2512-6. For example, the regulations provide that if the conversion occurs soon after the contract was sold, the fair market value is generally its original purchase price. However, if the conversion occurs after the annuity contract has been in force for some time and no further premium payments are to be made, fair market value is determined through the sale by the company of comparable contracts. If the conversion occurs after the annuity contract has been in force for some time and future premium payments are to be made, fair market value is determined through an approximation that is based on the interpolated terminal reserve at the date of the conversion, plus the proportionate part of the gross premium last paid before the date of the conversion which covers the period extending beyond that date; however, if because of the unusual nature of the contract the approximation is not reasonably close to the full value, this method may not be used. <u>Effective Date.</u> Regulation 1.408A-4 of the regulations is applicable to any Roth IRA conversion where an annuity contract is distributed or treated as distributed from a traditional IRA on or after August 19, 2005. IRS says no implication is intended concerning whether or not a rule to be adopted in these regulations is applicable law for taxable years ending before that date.

a. Rev. Proc. 2006-13, 2006-3 I.R.B. 315 (12/27/05). Provides safe harbors for determining the fair market value of an annuity contract in the conversion of a traditional IRA to a Roth IRA.

2. Mr. Gotbucks will be able to convert his traditional IRA to a Roth after 2009. TIPRA § 512 amends § 408A(c) to remove the $100,000 modified adjusted gross income limitation for the conversion of a traditional IRA to a Roth IRA, effective for taxable years beginning after 2009. For conversions made in 2010, the amount required to be included in gross income will be taxed ratably in 2011 and 2012.

3. Thomas v. Commissioner, T.C. Memo. 2005-258 (11/1/05). IRA distributions before age 59 ½ to taxpayer whose disability required scaling back from full-time to part-time work did not qualify for an exception to the § 72(t) penalty under § 72(t)(2)(A)(iii) because taxpayer was not disabled as defined in § 72(m)(7), which requires that taxpayer be 'unable to engage in any substantial gainful activity."

4. The **HERO Act** adds new Code § 219(f)(7) to allow members of the Armed Forces serving in a combat zone to make contributions to their individual retirement plans even if the compensation on which such contribution is based is excluded from gross income. Retroactive to 2004.

5. **Middle-aged geriatrics can make direct contributions from their IRAs to charities, and thus avoid deduction reductions under § 68. Pension Protection Act** § 1201 adds new Code § 408(d)(8) to permit tax-free distributions up to $100,000 directly to charities from IRAs owned by individuals over 70½ years of age. This provision has the effect of negating the erosion of charitable contribution deductions under § 68. Effective for 2006 and 2007.

6. Gee v. Commissioner, 127 T.C. No. 1 (7/24/06). An early distribution from the IRA into which taxpayer's deceased spouse's IRA was rolled over was a premature distribution subject to the 10% penalty tax under § 72(t) because the amount received from the deceased spouse's IRA lost its character as a distribution made to a beneficiary upon a decedent's death when it was transferred to taxpayer's separately owned IRA, and thus was not exempt from the 10% penalty tax under § 72(t)(2)(A)(ii).

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. **TIPRA** § 101 extends through 12/31/10 the 15 percent rates for capital gains and dividends which had been scheduled to expire in 2008.

2. **TIPRA** § 301 amends § 55(d)(1) to extend the increased AMT exemption amount for individuals for the 2006 year.

a. **TIPRA** § 302 amends § 26(a)(2) to extend the use of certain nonrefundable personal credits through the 2006 year.

3. **TIPRA** § 510 amends § 1(g)(2)(A) to increase the age below which the kiddy tax is applicable from 14 to 18, effective for years beginning after 2005.

B. Miscellaneous Income

1. Lindsey v. Commissioner, 422 F.3d 684 (8th Cir. 9/2/05). Although the taxpayer's physician testified that "suffered from hypertension and stress-related symptoms, including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence" as a result of the emotional distress inflicted by the defendant, the settlement agreement identified taxpayer's claims as tort claims for damage to his emotions, reputation and character. Physical symptoms that are merely manifestations of the underlying emotional distress for which damages are received do not result in the damages being treated as received on account of personal injury if there is no "direct causal link between any physical sickness suffered by [the taxpayer] and any damages paid out to him."

2. **Who Threw the Overalls in Mrs. Murphy's Chowder? Compensation for a personal injury that relate to something which could have been enjoyed tax-free is not income under the Sixteenth Amendment.** Murphy v. IRS, 460 F.3d 79 (D.C. Cir. 8/22/06), *Government motion for rehearing en banc*, 10/5/06. Taxpayer received environmental

whistleblower damages of $70,000 from the New York National Air Guard in 2000. The damages were awarded "for mental pain and anguish" and "for injury to professional reputation." The court (Judge Ginsburg) held that § 104(a)(2), as amended in 1996 to exclude non-physical personal injuries from the exemption, was unconstitutional because "compensation for a non-physical personal injury is not income under the Sixteenth Amendment if, as here, it is unrelated to lost wages or earnings." Judge Ginsburg's rationale is based upon the consideration that the award of compensatory damages was a substitute for a "normally untaxed" personal quality, good or asset, citing *O'Gilvie v. United States*, 519 U.S. 79 (1996) (punitive damages were taxable pre-1996 Act because they were not a substitute for a normally untaxed benefit), and *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944) ("In lieu of what were the damages awarded?"). Judge Ginsburg looked to the commonly understood meaning of the term "incomes" at the time of the adoption of the Sixteenth Amendment, and found that the term did not include damages for nonphysical personal injuries that were unrelated to lost wages or earning capacity.

- The issue is whether there was a pre-§ 104(a)(2) common law exclusion that survived the codification in 1918 and the amendments in 1996.
- The court rejected taxpayer's argument that her award was for "bruxism" which she argued was a physical injury or physical sickness.
- The court further dismissed the IRS as a defendant, holding that only the co-defendant United States was a proper defendant.

a. The Government has moved for rehearing *en banc*.

3. **California registered domestic partners may not use *Poe v. Seaborn* to split income between themselves because that case applies only to a property status arrangement that is "an incident of matrimony."** ILM 200608038, 2006 TNT 39-13 (2/24/06). A registered domestic partner under the California Domestic Partner Rights and Responsibilities Act of 2003 is required to include in gross income all of his earned income, and not one-half of the combined income earned by both registered domestic partners. The legal memorandum relies on *Commissioner v. Harmon*, 323 U.S. 44, 48 (1944), which in holding *Poe v. Seaborn* inapplicable to arrangements under an Oklahoma statute allowing married couples to elect community property status, stated, "The important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony."

C. Profit-Seeking Individual Deductions

1. **Fees paid for MBA were deductible because the degree did not qualify the taxpayer for a new trade or business.** Allemeier v. Commissioner, T.C. Memo. 2005-207 (8/31/05), *motion for fees denied*, T.C. Memo. 2006-28 (2/16/06). Orthodontic appliance salesman who was promoted to a management position after starting MBA could deduct cost of MBA; education was not a "minimum requirement" because promotion was not contingent on beginning or completing MBA program, and it did not qualify taxpayer for a new trade or business because the basic nature of taxpayer's work activities did not change as a result of additional education, even though taxpayer was awarded new titles and positions and advanced more rapidly; the MBA merely improved pre-existing skills.

- May an employer avoid both the § 127 dollar limit on reimbursement of the costs of an employee's MBA program and the § 127 nondiscrimination requirement by treating payment of such costs as s § 132(a)(3) working fringe benefit?

- Under *Warren v. Commissioner*, T.C. Memo. 2003-175, expenses of obtaining a college degree were held nondeductible because they qualified the taxpayer for a new trade or business.

2. **You can rely on Eeny, on Meeny and on Miny -- but you cannot rely on Moe. A tax lawyer may not rely on his accountants to avoid penalties.** Kovacevich v. Commissioner, 97 AFTR2d 2006-1952 (9th Cir. 4/12/06) (unpublished memorandum opinion). The amount paid by an attorney to settle a lawsuit brought against him by a former client was an unreimbursed employee business expense because the attorney was a statutory employee of his wholly owned legal professional corporation through which he practiced. Therefore, the amount paid was deductible only as a miscellaneous itemized deduction, subject to the various applicable limitations.

- A § 6662 penalty was imposed despite taxpayer's claim that he relied on his outside accountants [Moe & Associates] because he had a "reputation as a competent tax attorney" with "self-avowed expertise in the field of tax law."

D. Hobby Losses and § 280A Home Office and Vacation Homes

E. Deductions and Credits for Personal Expenses

1. **When will trust investment advisory fees get up off the § 67 floor?** Rudkin Testamentary Trust v. Commissioner, 124 T.C. No. 19 (6/27/05) (reviewed, 18-0), *aff'd*, __ F.3d __ (2d Cir. 10/18/06) (2-0). The Tax Court (Judge Wherry) holds that amounts paid for investment management advice by trusts set up by a family involved in the founding of the Pepperidge Farm food products company (which was sold to Campbell Soup Company in the 1960s) are not subject to the § 67(e) exception to the § 67(a) floor of 2 percent of AGI (which limits the deductibility of employee business expenses and miscellaneous itemized deductions to amounts exceeding that floor). In reaching this result, the Court determined that these expenses did not qualify for the exception in § 67(e)(1) under which costs paid or incurred in connection with the administration of a trust that wouldn't have been incurred if the property weren't held in the trust are allowed as deductions in arriving at adjusted gross income. The Tax Court explained that the statutory text of § 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2% floor where two requirements are satisfied: 1) The costs are paid or incurred in connection with administration of the trust; and 2) the costs would not have been incurred if the property were not held in trust.

- In 1992, the Tax Court held that a trust's investment advice costs were subject to the 2% floor. (*O'Neill Trust v. Commissioner*, 98 TC 227 (1992). However, the Sixth Circuit reversed the Tax Court and held that investment counseling fees paid by the trust to aid the trustees in discharging their fiduciary duty to the trust beneficiaries were not subject to the 2% floor under the § 67(e)(1) exception. (71 AFTR 2d 93-2052 (6th Cir. 1993)). Subsequently, the Sixth Circuit approach was rejected by the IRS (*nonacq*, 1994-2 C.B. 1); the Federal Circuit (*Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001)); and the Fourth Circuit (*Scott v. United States*, 328 F.3d 132 (4th Cir. 2003)). In reaching their decision, the Federal and Fourth Circuits emphasized the importance of not interpreting the statute so as to render superfluous any portion of it. They said that if courts were to hold that a trust's investment-advice fees were fully deductible, the second requirement of § 67(e)(1) would have been rendered meaningless.

- The Sixth Circuit's rationale was stated as follows:

> The Tax Court reasoned that "individual investors routinely incur costs for investment advice as an integral part of their investment activities." Nevertheless, they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust. (994 F.2d at 304)

a. **The Second Circuit affirms and gives a third interpretation of "an unambiguous statute."** __ F.3d __ (2d Cir. 10/18/06) (2-0). Judge Sotomayer held that § 67(e) was unambiguous and permitted a full deduction only for those types of trust expenses that an individual could not possibly incur.

2. **No 10-percent-of-AGI floor for the deduction of Katrina losses.** Under the **Katrina and GO Zone Acts**, new § 1400S(b) is added, under which individual taxpayers would be permitted to claim casualty or theft losses attributable to Hurricanes Katrina, Rita and Wilma regardless of whether the loss exceeds $100, and in addition, these personal casualty or theft losses would be deductible without regard to whether the loss exceeds 10 percent of a taxpayer's adjusted gross income.

3. **Specific rules trump logic.** Lofstrom v. Commissioner, 125 T.C. No. 13 (11/22/05). A third-party debt instrument transferred in satisfaction of a state court ordered alimony payment is not "cash" and thus is not alimony for purposes of § 71. Judge Kroupa applied Reg. § 1.71-1T(b), Q&A-5, which requires payment solely by cash, check or money order in denying § 215 deduction to the transferor.

4. **We now have a uniform definition of "child" but it is not very user-friendly for those who understood the former definitions.** Sections 201-208 of the **Working Families Tax Relief Act of 2004** provide a uniform definition of "child" for head of household, dependent care credit, child tax credit, earned income tax credit, and dependent exemption purposes for years beginning after 2004. This changes prior law by making irrelevant the fact that Forms 8332 were signed by the custodial parent. Instead, what would be required to shift the dependency deduction to the non-custodial parent is a provision in the divorce decree or separation agreement.

- Under the pre-2004 version of § 152(e)(2), the noncustodial parent was treated as having provided over half of the child's support for the year if the custodial parent signed a written declaration that he would not claim the child as a dependent for any tax year beginning within that calendar year, and the noncustodial parent attached the declaration to his return for the taxable year in which he claimed the dependency exclusion. The declaration by the custodial parent could pertain to only one year, or could specify that it applied to two or more years, and a permanent declaration might be made at the time of the divorce. Temp. Reg. § 1.152-4T(a) Q & A 4. The actual signature of the custodial spouse on the declaration was crucial to shifting the exemption to the noncustodial parent. The pre-2004 version of § 152(e)(2) also applied to determine which of the never-married and non-cohabiting parents of a minor child was entitled to the dependency exemption.

- As amended by the **Working Families Tax Relief Act of 2004**, § 152(e)(2) provides that the noncustodial spouse will be entitled to the dependency exemption for the couple's minor child if a decree of divorce or separate maintenance or written separation agreement between the parents provides either (1) that the noncustodial parent is entitled to the dependency exemption for the child, or (2) that the custodial parent will sign a written declaration that she will not claim the child as a dependent for a particular taxable year. The 2004 amendments change the rules in a number of respects. First, amended § 152(e)(2), rather than deeming the noncustodial parent to have provided over one-half of the child's support, now treats the child as a "qualifying child" under § 151 with respect to the noncustodial parent. This has the effect of assuring (consistently with prior law) that if the right to the exemption is awarded to the noncustodial spouse, that spouse also obtains the right to claim the § 24 child credit. Second, under the amended version of § 152(e)(2), unlike under the pre-2004 version, a provision in a divorce instrument awarding the exemption to the noncustodial spouse is effective without any action on the part of the custodial spouse to sign a waiver. Furthermore, under the strict wording of the statute, if the divorce instrument does not specifically award the dependency exemption to the noncustodial spouse but directs the custodial spouse to sign the waiver, it appears that the right to claim the exemption is effectively transferred to the noncustodial spouse even if the custodial spouse subsequently refuses or otherwise fails to sign the waiver. Thus, the divorce instrument is now the key document, whereas under prior law the written waiver by the custodial spouse was the key document. Finally, unlike the pre-2004 version of § 154(e), which permitted parents who were never married to agree that the noncustodial spouse would be entitled to the dependency exemption through a waiver by the custodial parent, the current version of § 152(e)(2) requires a provision in a divorce or written separation agreement. Unless the courts interpret the term "written separation agreement" to encompass agreements between parents who were never married, the noncustodial parent of a child whose parents never married will not be able to obtain the dependency exemption with respect to the child. In such a case, § 152(e)(1)(A)(iii) always awards the exemption to the custodial parent.

a. **Technical Corrections under the GO Zone Act of 2005**. The Gulf Opportunity Zone Act of 2005 contains technical corrections to previously enacted legislation including the Working Families Tax Relief Act of 2004 and The American Jobs Creation Act of 2004. The custodial parent is defined by the GO Zone Act as the parent having custody of the child for the greater portion of the calendar year. The Working Families Tax Relief Act of 2004 had changed the wording of § 152(e) to say that the custodial parent was "the parent with whom a child shared the same principal place of abode for the greater portion of the calendar year." This meant that beginning in 2005, the parent with whom the child lived for the greater portion of the year was the custodial parent (and therefore "in charge" of the personal exemption for that child) even though the other parent had been granted legal custody of the child by the courts. Now, the technical correction made by the GO Zone Act of 2005 changes the language to say that the custodial parent "means the parent having custody for the greater portion of the year." This is identical to the definition of the "custodial parent" prior to the amendment of § 152(e) by the Working Families Tax Relief Act of 2004. Therefore, the Go Zone Act of 2005 has changed the definition of the custodial parent back to the old definition effective as of January 1, 2005. The effect of this change is that (as for 2004 and previous years) a parent is the custodial parent if the judge grants the parent legal custody of the child for the greater portion of the year. However, if the parents have joint legal custody, then (as under the law before its amendment by the Working Families Tax Relief Act of 2004) the parent with whom the child spends the greater portion of the year will be the custodial parent.

F. Education

1. **Section 529 plan treatment made permanent.** The **Pension Protection Act** § 1304 provides that the changes contained in the 2001 Act [EGTRRA] with respect to Code § 529 qualified tuition programs will be permanent, i.e., will not sunset in 2011. These include the provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax, and the provisions that permit rollovers from one beneficiary to another [including first cousins].

VI. CORPORATIONS

A. Entity and Formation

1. **Debt vs. equity discussed at length.** Indmar Products Co. v. Commissioner, 444 F.3d 771 (6th Cir. 4/14/06) (2-1), *rev'g* T.C. Memo. 2005-32. In a case disallowing interest deductions for the years 1998-2000, Judge McKeague held that advances made beginning in the 1970s to a company by its shareholders more closely resembled debt than equity because of the fixed [10 percent] interest rate and regular monthly interest payments, as well as the execution of demand promissory notes beginning in 1993. The opinion contains a lengthy discussion of the debt vs. equity issue.

- In his concurring opinion Judge Rogers, in drawing the distinction between issues of fact and issues of law, stated:

> For instance, assume an ordinance taxes the keeping of pet dogs. Jo is assessed a tax for keeping Fido, and Jo appeals. The question "Is Fido a dog?" may be factual or it may be legal. If Jo claims only that Fido is a really a cat, then the issue is factual. No one argues that the legal definition of dog includes cats; the only dispute is regarding the actual nature of Fido. On the other hand, if both parties agree that Fido is a prairie dog, the question "Is Fido a dog?" is a purely legal one. There is no dispute about the nature of Fido; the only dispute involves what the legal meaning of "dog" is. Of course if the city says Fido is a schnauzer while Jo says that Fido is actually a prairie dog, the question "Is Fido a dog" is mixed if *both* legal and factual aspects of the seemingly single question are in dispute.

- Judge Moore dissented on the ground that the Tax Court's findings were not clearly erroneous.

B. Distributions and Redemptions

1. **The IRS was "buffeted" when it attempted to trace a linkage between taxpayer's borrowings and its investments in portfolio stock.** OBH, Inc. (formerly Berkshire Hathaway Inc.) v. United States, 2005-2 U.S.T.C. ¶50,627 (D. Neb. 10/28/05). The court holds that taxpayer is entitled to a full dividends received deduction because § 246A, which reduces the dividends-received deduction allowable under § 243(a) for dividends that are paid on "debt-financed portfolio stock," was not applicable. The court looked to legislative history (House Report), which stated that portfolio indebtedness is debt that is "clearly incurred for the purpose of acquiring dividend paying stock or otherwise directly traceable to such an acquisition."

- It found that the proceeds of the four borrowings in question were not able to be traced to specific purchases of portfolio stock, i.e., they were not "directly attributable" to portfolio stock purchases. It further held that "directly traceable" should be given a "plain meaning" definition, i.e., that "direct" connotes an "immediate result," and the IRS failed to show an immediate connection between the debt proceeds and the stocks. The court further found that the IRS tracings do not satisfy the "purpose" test either.

- The opinion states that the court is cognizant of the fact that current statutory and regulatory regime makes it virtually impossible for the Service to trace debt proceeds and thus assess tax deficiencies under § 246A against companies like OBH who engage in numerous investment transactions. However, any decision to loosen the "direct" connection required between debt-proceeds and the purchase of dividend-paying stocks must be made by Congress or the Service, not the courts. In fact, the Service, apparently recognizing the difficulty in applying § 246A to companies like Berkshire, has already taken steps to alter the necessary linkage required by § 246A. On May 7, 2004, the Service issued an announcement requesting comments on whether regulations should be adopted that would supplement the specific tracing rule in § 246A with a pro rata allocation rule to determine the use of borrowings that are not traceable to a specific use. See 69 F.R. 25534.

- Compare § 265(a)(2), relating to the treatment of interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations.

2. **Basis can live long after the stock is "redeemed." Who'd a thunk it?** REG-150313-01, Redemptions Taxable as Dividends, 67 F.R. 64331 (10/18/02). The IRS has proposed replacing the "proper adjustment" to the basis of remaining stock rule of Reg. § 1.302-2(c), which takes into account the unused basis of redeemed stock when the redemption is treated as a § 301 distribution. Prop. Reg. § 1.302-5 would provide that the redeemed shareholder [who is taxed under § 301] would retain the basis of the redeemed stock as a basis item separate from any remaining shares, whether or not the shareholder continues to actually own the stock of the redeeming corporation, and take it into account as a loss deduction at some future date. The loss subsequently can be claimed under either the "final inclusion date" rule or the "accelerated loss inclusion date" rule. The "final inclusion date" rule allows the loss deduction on the date on which the redeemed shareholder would have qualified under § 302(b)(1), (2) or (3) if the facts on that date had been the facts immediately after the redemption, or alternatively, when an individual shareholder dies or a corporate shareholder is liquidated in a transaction to which § 331 applies. The "accelerated loss inclusion date" rule allows the redeemed shareholder to claim a loss attributable to the unutilized basis when the shareholder subsequently recognizes a gain on stock of the redeeming corporation, but the loss may be claimed only to the extent of the gain recognized. Because the loss attributable to the basis of the redeemed stock is treated as recognized on the redemption date, the attributes (e.g., character and source) of the loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. These rules apply to § 304(a)(1) transactions taxed under § 301 by treating the unutilized basis in the redeemed corporation stock as basis in the stock of the acquiring corporation. Special rules apply to partnerships, in consolidated returns [Prop. Reg. § 1.1502-19(b)(5)], and to foreign corporations. These rules do not apply to redemptions of § 306 stock, but they do generally apply even in the case of a corporation wholly owned by a single shareholder, whether a corporation or an individual.

- These regulations are a reaction, in part, to basis shifting transactions, such as that described in Notice 2001-45, 2001-33 I.R.B. 129 [the so-called Bank of America transaction].

• It has been noted that if nuclear disaster ever overcomes the Earth, only the cockroach and basis would survive.

a. **They ran the proposed regulations up the flagpole, but nobody saluted. Back to the drawing board "for further study."** Announcement 2006-30, 2006-19 I.R.B. 879 (5/8/06). Announces the withdrawal on 4/19/06 of the 2002 proposed regulations on the treatment of the basis of stock redeemed or treated as redeemed in distributions governed by § 301.

C. Liquidations

D. S Corporations

1. **Members of one (greatly extended) family are treated as one shareholder.** Section 231 of the **Jobs Act of 2004** amends § 1361 to treat members of a family as one shareholder at the election of any family member. Shareholders with a common ancestor going back six generations are members of the same family.

• This means that a shareholder and his fifth cousin are members of the same family. This would have the effect of making the entire population of Arkansas members of the same family.

a. **How many S corporation shareholders know the name of any of their great-great-great-great grandfathers?** Notice 2005-91, 2005-51 I.R.B. 1164 (11/22/05). Advance notice of what regs will say under § 1361(c)(1)(D) election to aggregate family members for 100 shareholder limit. Lists additional shareholders who will be counted in aggregation (trust beneficiaries, etc.) Describes the manner by which the election to treat members of a family as one shareholder may be made for taxable years of the S corporation beginning after 12/31/04. "The election is made by notifying the corporation to which the election applies. The notification shall identify by name the member of the family making the election, the "common ancestor" of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective." Members of the family also include beneficiaries of permitted trusts, etc. A smaller family may be subsumed into a larger family, with members of the larger family all being counted as one shareholder.

2. **Pension Protection Act** § 1203 amends Code § 1367(a)(2) to provide that on the charitable contribution of appreciated property by an S corporation, the reduction in shareholder basis in the S corporation stock is limited to shareholder's pro rata share of the basis of the contributed property.

3. <u>Garwood Irrigation Co. v. Commissioner</u>, 126 T.C. No. 12 (5/1/06) An S corporation that is due a refund in excess of $10,000 with respect to a § 1374 built-in gains tax is entitled to interest at two percentage points above the federal short term rate. Interest is not limited to the lower corporate rate of one-half percent above the AFR because § 6621 applies only to C corporations, not S corporations; however, because taxpayer was a corporation, the noncorporate rate of three percent above the AFR did not apply – even though taxpayer was an S corporation.

E. Reorganizations

1. **When to measure the value of consideration to determine whether continuity of interest exists: It is the business day before the day on which the binding contract is entered into.** T.D. 9225, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest, 70 FR 54631-01 (9/15/05). As amended, Reg. § 1.368-1(e)(2) provides that if the consideration to be provided to the target corporation shareholders is fixed in the

binding contract and includes only stock of the issuing corporation and money, the determination of whether the continuity of interest requirement is satisfied is based on the value of the consideration to be exchanged for the proprietary interests in the target corporation as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization,. The number of shares of stock of the acquiring corporation that will be exchanged for stock of the target corporation generally is fixed by agreement at a time significantly in advance of the actual closing of the transaction. The regulation is intended to eliminate uncertainty where the target corporation shareholders receive cash (or debt instruments) in addition to acquiring corporation stock and, at the time the transaction is agreed upon, the amount of the boot equals the value of the agreed upon number of shares of the acquiring corporation stock to be received. Otherwise, the transaction might fail to satisfy the continuity of interest requirement if the value of the acquiring corporation's stock declined between the date the parties agreed to the terms of the transaction (the signing date) and the date the transaction closed if the quantitative aspect of the continuity of interest requirement were tested on the closing date rather than the signing date.

- Under Reg. § 1.368-1(e)(2)(iii), a contract that provides for either the percentage of the number of shares of each class of target corporation stock, or the percentage by value of the target corporation shares, to be exchanged for issuing corporation stock should be treated as providing for fixed consideration, as long as the target corporation shares to be exchanged for issuing corporation stock and the target corporation shares to be exchanged for consideration other than issuing corporation stock each represents an economically reasonable exchange. A condition outside the control of the parties does not prevent an instrument from being a binding contract. Examples of a condition outside the control of the parties include the completion of a tender offer being subject to a shareholder vote or the target corporation's shareholders tendering a sufficient amount of target stock. Reg. § 1.368-1(e)(2)(iii)(B)(2) provides that if the target corporation's shareholders may elect to receive either stock or money and the maximum amount of money that the target shareholders might receive can be determined, continuity of interest will be tested by assuming that the minimum number of shares will be issued and the maximum amount of money will be received, without regard to the number of shares and amount of money actually exchanged for the target corporation stock. Reg. § 1.368-1(e)(2)(iii)(C)(2) provides that stock that is escrowed to secure customary pre-closing covenants and representations or customary target warranties is not treated as contingent consideration, which would render the safe harbor unavailable. However, escrowed consideration that is forfeited, is not taken into account in determining whether the continuity of interest requirement has been met. Reg. § 1.368-1(e)(2)(v), Ex. 2.

- The regulations that include an example that lowers the administratively sanctioned threshold for adequate quantitative continuity of interest to 40 percent. Reg. § 1.368-1(e)(2)(v), Ex. (1). Conversely, Reg. § 1.368-1(e)(2)(v), Ex. (2), indicates that stock consideration of 25 percent is insufficient.

- The number of shares of stock of the acquiring corporation that will be exchanged for stock of the target corporation generally is fixed by agreement at a time significantly in advance of the actual closing of the transaction. Suppose that in a statutory merger the target corporation shareholders receive cash (or debt instruments) in addition to acquiring corporation stock and, at the time the transaction is agreed upon, the amount of the boot equals the value of the agreed upon number of shares of the acquiring corporation stock to be received. The transaction might fail to satisfy the continuity of interest requirement if the value of the acquiring corporation's stock declined between the date the parties agreed to the terms of the transaction (the signing date) and the date the transaction closed if the quantitative aspect of the continuity of interest requirement were tested on the closing date rather than the signing date. Prop. Reg. § 1.368-1(e)(2) (2004) would eliminate this uncertainty by providing that the determination of whether the continuity of interest requirement is satisfied is based on the value of the consideration to be exchanged for the proprietary interests in the target corporation as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization, if the consideration to be provided to the target corporation shareholders is fixed in such contract and includes only stock of the issuing corporation and money. A condition outside the control of the parties would not prevent an instrument from being a binding contract. Examples of a condition outside the control of the parties include the completion of a tender offer being subject to a shareholder vote or the target corporation's shareholders tendering a sufficient amount of target stock. If the target corporation's shareholders may elect to receive either stock or money and the maximum amount of money that the target shareholders might receive can be determined, continuity of interest will be tested by assuming that the minimum number of shares will be issued and the maximum amount of money will be received, without regard to the number of shares and amount of money actually exchanged for the target corporation stock

2. T.D. 9242, Statutory Mergers and Consolidations, 71 F.R. 4259 (1/26/06). These final regulations adopt proposed regulations (REG-117969-00) issued in 2005 based upon temporary regulations (T.D. 9038) issued in 2003. The final regulations replace the requirement in Reg. § 1.368-2(b)(1) that a merger or consolidation under § 368(a)(1)(A) be effected under the laws of a state, etc. with more general language that qualifies transactions "effected pursuant to the statute or statutes necessary to effect the merger or consolidation." Mergers involving disregarded entities qualify if all the assets and liabilities of the target are transferred to the acquirer and the target ceases to exist.

F. Corporate Divisions

G. Miscellaneous Corporate Issues

1. **Sale of shares by a taxpayer to his brother in a closely held corporation claiming a net operating loss deduction resulted in a § 382 change of control that triggered the limitation on NOL carryovers.** Garber Industries Holding Co. v. Commissioner, 124 T.C. 1 (1/25/05). The Tax Court (Judge Halpern) held that the family aggregation rule of § 382(1)(3)(A)(i) applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of § 382(1)(3)(A)) of the loss corporation. Thus, the sale of stock from one sibling to another that resulted in a more than 50 percent increase in stock ownership by the purchasing sibling triggered the application of § 382. The fact that each sibling and either of their parents would be viewed as a single shareholder did not result in the siblings be treated as a single shareholder where neither of their parents was a shareholder. The court recognized the possibility that the rule it announced might result in arbitrary distinctions between cases in which a parent of the siblings also was a shareholder and cases in which the parent was not a shareholder, but concluded that the announced rule was the one most compatible with the statutory language and legislative history.

- One of the Garber brothers (Charles) had his interest in the corporation decreased from 68 percent to 19 percent and the other brother (Kenneth) had his interest increased from 26 percent to 65 percent in a 1986 "D" reorganization. In 1988, Kenneth sold all of his remaining shares to Charles, with the result that Charles's interest in the corporation increased from 19 percent to 84 percent. The parents of Charles and Kenneth were both deceased, and, when living, never had any ownership interest in the corporation.

- The court refused to follow taxpayers' argument that siblings are treated as one individual under the NOL aggregation rule, which provides that an individual and all members of his family described in § 318(a)(1), i.e., spouses, children, grandchildren and parents, are treated as one individual.

- Judge Halpern also refused to follow the Commissioner's argument that the family aggregation rule does not apply because none of the parents and grandparents of the Garber brothers were alive at the beginning of the 3-year testing period immediately preceding the 1998 transaction. Instead, he concluded that a third interpretation was correct, i.e., that the family aggregation rule of § 382(1)(3)(A)(i) applies from the perspective of individuals who are shareholders of the loss corporation (as determined under the attribution rules of § 382(1)(3)(A)), and that the brothers were unrelated under this perspective. Judge Halpern held that the family aggregation rule of § 382(1)(3)(A)(i) applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of § 382(1)(3)(A)) of the loss corporation. Thus, the sale of stock from one sibling to another that resulted in a more than 50 percent increase in stock ownership by the purchasing sibling triggered the application of § 382. The fact that each sibling and either of their parents would be viewed as a single shareholder did not result in the siblings be treated as a single shareholder where neither of their parents was a shareholder. The court recognized the possibility that the rule it announced might result in arbitrary distinctions between cases in which a parent of the siblings also was a shareholder and cases in which the parent was not a shareholder, but concluded that the announced rule was the one most compatible with the statutory language and legislative history.

a. **Affirmed by the Fifth Circuit.** 435 F.3d 555, 2006-1 U.S.T.C. ¶50,109 (5th Cir. 1/9/06). Held, that the Tax Court properly interpreted § 382 as applied to a sale of stock between two shareholder brothers when no parent or grandparent was a shareholder of the loss corporation because § 382 incorporates the limited family description from § 318 limits the relatives of a shareholder to spouse, parents, children and grandchildren.

VII. PARTNERSHIPS

A. Formation and Taxable Years

B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

1. REG-144620-04, Partner's Distributive Share, 70 F.R. 69919 (11/18/05). Proposed regulations that *inter alia* provide rules for testing the substantiality of a § 704(b) allocation where the partners are look-through entities or members of a consolidated group and revise the existing rules for determining the partners' interests in a partnership. They provide that the interaction of a partnership allocation with the tax attributes of owners of look-through entities must be taken into account when testing the substantiality of the allocation to a partner that is a look-through entity, and, similarly, tax attributes of a consolidated group must be taken into account with respect to the allocation to a partner that is a member of the consolidated group.

2. Burke v. Commissioner, T.C. Memo. 2005-297 (12/27/05). Partner is taxable on his share partnership income even though he did not receive any of it. Judge Wells stated:

> Petitioner argues, however, that the existence of a real controversy between petitioner and Mr. Cohen rendered the amount of his distributive share indefinite and that the partnership receipts in escrow are "frozen" and therefore unavailable to petitioner. Petitioner cites section 703(a) for the proposition that the taxable income of a partnership is computed in the same manner as that of an individual and cites several cases to support his argument that his dispute with his former partner postpones the inclusion of his distributive share because he does not have a claim of right to the income. ***
>
> The income was earned by the partnership during 1998, and there was nothing conditional or contingent about its receipt. Petitioner, therefore, was taxable on his distributive share of the partnership's profits for 1998, even though he did not receive it. See First Mechs. Bank v. Commissioner, 91 F.2d at 279. It is irrelevant that petitioner still may not know the full extent of the partnership income because of the deposits stolen by his partner, Mr. Cohen; the nonappearance of the deposits on the partnership books is not determinative. ***a partner is taxable on his distributive share of partnership income when realized by the partnership despite a dispute among the partners as to their respective distributive shares.
>
> Petitioner does not dispute the facts pertinent to the calculation of his distributive share of the partnership's income for the year in issue. Rather, petitioner argues that the deposits to the partnership's account for that year are not income to him as a matter of law. As we discussed above, a partner must include his distributive share of partnership income whether or not it is distributed to him. Accordingly, we conclude that respondent is entitled to summary judgment on the issue of the calculation of petitioner's distributive share.

3. REG-1444620-04, Partner's Distributive Share, 2005-50 I.R.B. 1141, 70 Fed. Reg. 69919. Proposed amendments to Reg. § 1.704-1(b)(2)(iii) to apply substantiality test by testing interaction of partnership items with items of owners of a partner that is a pass-entity, e.g., partnership, S corporation, trust.

C. Distributions and Transactions Between the Partnership and Partners

1. Notice 2006-14, 2006-8 I.R.B. 498 (2/2/06). The IRS has requested comments on how to simplify the current regulations under § 751(b) (applicable to partnership distributions treated as sales or exchanges) on how to determine a partner's share of "hot assets" and how to treat disproportionate distributions.

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. AD Global Fund LLC v. United States, 67 Fed. Cl. 657 (9/16/05). Section 6629(a) provides an extended statute of limitations rather than a separate period of limitations; issuance of Final Partnership Administrative Adjustment (FPAA) suspends period of limitations under IRC § 6501(a)), *motion to certify appeal granted*, 68 Fed. Cl. 663 (2005).

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases

1. **Significant government victory in tax shelter case! Lack of economic substance and step-transaction findings result in both the 20- and 40-percent penalties.** Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 2004-2 U.S.T.C. ¶ 50,351

(D. Conn. 8/27/04). Judge Janet Bond Arterton poured out taxpayers by holding that the tax shelter transaction [under which preferred stock with an inflated basis was contributed to a partnership in a carryover basis transaction] lacked economic substance (or, in the alternative, that the step transaction doctrine required that it be recast into a direct sale of preferred stocks to taxpayers with the result that the basis was equal to the amount they paid) and by upholding the imposition of (in the alternative) both the 40-percent gross valuation misstatement and the 20-percent substantial understatement penalties. After that introductory statement, the remainder of the 198-page opinion was all downhill for taxpayers and their lawyers.

- The inflated basis was the result of several cross-border lease-stripping transactions which left a foreign entity holding several million dollars worth of preferred stocks at a basis $385 million greater than value. The lease-stripping transactions were supported by "should" tax opinions issued by Shearman & Sterling when they were entered into.

- Taxpayers' in-house tax counsel became interested in the possible utilization of the losses when approached by Don Turlington, who suggested that the foreign entity contribute the preferred stock to one of taxpayers' related partnerships, after which the foreign entity would have its partnership interest redeemed. King & Spalding agreed to furnish a "should" tax opinion that taxpayers could utilize the foreign entity's losses, but did not actually provide the opinion until almost a year after the partnership filed the return that took the losses.

- Holdings included: (1) the burden of proof did not shift to the government under § 7491 because taxpayers failed to provide a PowerPoint presentation and accompanying handout for a presentation of Myron Scholes to the other eleven of taxpayers' principals and taxpayers' net worth was not unambiguously shown to be under $7 million; (2) the transaction lacked economic substance because the reasonably expected return on it could not have resulted in a profit (with the court calling into question the credibility of the former King & Spalding lawyer who was the primary drafter of the opinion); (3) the "end result" variety of the step transaction doctrine — the most liberal of the three varieties — was applied to conclude that taxpayers acquired the preferred stocks by purchase at a fair market value basis; (4) the gross valuation misstatement resulted from the claimed adjusted basis of the preferred stocks being more than 400 percent of the adjusted basis that was found by the court to equal fair market value; (5) the substantial understatement penalty was applied based upon taxpayers' failure to show any authority that held a transaction devoid of economic substance could produce deductible losses; (6) the § 6664(c) "reasonable cause ... and ... good faith" exception did not apply because taxpayers failed to prove that the King & Spalding oral advice provided to it before 4/15/98 [the day it filed the relevant partnership return] satisfied the "reasonable cause" defense because of the vagueness and lack of credibility of testimony as to the content of the oral advice; and (7) the 1/27/99 written King & Spalding opinion did not provide reasonable cause because its facts were unsubstantiated and its legal analysis unsatisfactory in that it failed to discuss Second Circuit cases. Judge Arterton summarized the opinion as follows:

> Finally, no other evidence such as companion memoranda discussing the application of the Second Circuit's decisions in Goldstein, Gilman, Grove, Blake, and Grove, or the Tenth Circuit's decision in Associated to the actual facts of the [foreign entity] transaction was offered to show research for King & Spalding's legal analysis and opinions. Such background research does not involve obscure or inaccessible caselaw references, is basic to a sound legal product, especially for "should" level opinion and a premium of $400,000. With hourly billing totals exceeding $100,000 there could not have been research time constraints.

In essence, the testimony and evidence offered by Long Term regarding the advice received from King & Spalding amounted to general superficial pronouncements asking the Court to "trust us; we looked into all pertinent facts; we were involved; we researched all applicable authorities; we made no unreasonable assumptions; Long Term gave us all information." The Court's role as factfinder is more searching and with specifics, analysis, and explanations in such short supply, the King & Spalding effort is insufficient to carry Long Term's burden to demonstrate that the legal advice satisfies the threshold requirements of reasonable good faith reliance on advice of counsel."

- Myron Scholes and Robert Merton, who shared the 1997 Nobel prize in Economics were two of taxpayers' twelve principals. Taxpayers were the component parts of one of the highest-flying hedge funds until it had to be rescued from collapse by 14 banks [acting at the instigation of the Federal Reserve] providing $3.65 billion to take the hedge fund over.

- Query about where the substantial authority penalty fits when you have told all to a tax professional and he tells you that you have substantial authority — but the court finds that the underlying facts are different from the facts that both you and the tax professional believe to be true?

- Is there a duty on a client to read and understand a tax opinion beyond checking that the facts upon which the opinion is based are correct?"

a. **On the appeal of the imposition of penalties, the Second Circuit affirms in an unpublished summary order.** Long-Term Capital Holdings, LP v. United States, 2005 U.S. App. LEXIS 20988 (2d Cir. 9/27/05) (unpublished). The court states that taxpayer was not required to "second-guess the advice of its tax experts" but instead that it did not receive relevant tax advice upon which it relied in reporting the $106 million loss, and – even if it had received such advice – it could not have relied upon the opinion's assumptions of (1) "valid and substantial business purpose independent of federal income tax considerations, (2) reasonable expectation of a material pre-tax profit, and (3) no preexisting agreement on the part of Onslow Trading Company to sell its partnership interest to the Long-Term Capital Management partnership. The court upheld the 40 percent penalty based upon a basis misstatement [specifically covered by the statute, but different from the typical valuation misstatement to which the penalty has been applied in the past] and held that a misstatement resulting from a legal dispute [as opposed to a factual dispute] was also covered by the penalty and that the 40 percent penalty applied where a transaction is "recast" for tax purposes under the economic substance doctrine.

2. **Significant taxpayer victory when its summary judgment motion was granted; the contingent liability transaction was upheld despite its being a listed transaction under Notice 2001-17.** Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 10/20/04, *revised*, 10/22/04). Government appeal pending. Judge Quarles held that the transaction could not be disregarded as a sham because it had economic implications for the parties to the transaction as well as to the beneficiaries of taxpayer's health plans.

- Under the Fourth Circuit test in *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (1985), a transaction will be treated as a sham only if "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." Taxpayer conceded for purposes of its motion "that tax avoidance was its sole motivation." The court held that "[a] corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions."

- Note how Judge Quarles shifted the second prong of the test from "reasonable possibility of profit" to "bona fide business transaction."

- The transaction was a listed tax shelter under Notice 2001-17, 2001-9 I.R.B. 730.

- In 1998, Black & Decker sold three of its businesses and realized significant capital gains. That same year, Black & Decker created Black & Decker Healthcare Management Inc. (BDHMI), to which it transferred approximately $561 million dollars, with BDHMI assuming $560 million dollars in contingent employee healthcare claims against Black & Decker. Black & Decker then sold the BDHMI. stock to a third-party for $1 million dollars, and claimed a $560 million loss on the grounds that its basis in the BDHMI stock was $561 million dollars. The court concluded that §§ 357(c)(3) and 358(d)(2) applied and that Black & Decker's basis in the BDHMI stock properly was not reduced by the amount of the contingent employee healthcare claims. It rejected the IRS contention that the claims had to be deductible by the transferee (BDHMI), and, based upon the legislative history of § 357(c)(3), concluded that there was no reduction in basis because the contingent claims were liabilities that would have been deductible by the transferor shareholder had it paid the claims.

a. **Government's summary judgment motion had been denied earlier on a pro-taxpayer rationale.** Black & Decker Corp. v. United States, 2004-2 U.S.T.C. ¶ 50,359 (D. Md. 8/3/04). As the facts were stated in the opinion,

> In 1998, B & D sold three of its businesses. As a result of these sales, B & D generated significant capital gains. Id. That same year, B & D created Black & Decker Healthcare Management Inc. ("BDHMI"). B & D transferred approximately $ 561 million dollars to BDHMI along with $ 560 million dollars in contingent employee healthcare claims in exchange for newly issued stock in BDHMI. B & D sold its stock in BDHMI to an independent third-party for $ 1 million dollars. Because B & D believed that its basis in the BDHMI stock was $ 561 million dollars, the value of the property it had transferred to BDHMI, B & D claimed approximately $ 560 million dollars in capital loss on the sale, which it reported on its 1998 federal tax return. B & D applied a portion of the capital loss to offset its capital gains from selling the three businesses, and carried back and carried forward the remaining capital loss to offset gains in prior and future tax years. (citations omitted)

- The court went on to analyze and conclude that §§ 357(c)(3) and 358(d) applied so the basis of the subsidiary's stock is not reduced by the amount of the contingent employee healthcare claims. It rejected the IRS contention that the claims had to be deductible by the transferee [the subsidiary], and held that (based upon the 1978 legislative history to § 357(c)(3)) the only requirement is that the claims must be deductible by taxpayer [the transferor corporation].

- Section 358(h), added in 2000 and amended in 2002, would preclude this result for assumptions of liability after its 10/18/99 effective date. If the basis of stock received in a § 351 transaction otherwise would exceed its fair market value, § 358(h) requires that the basis of the stock be reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any § 357(c)(3) liability that was assumed by the corporation. For this purpose, "liability" is broadly defined to include "any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of [the income tax]."

b. **Black & Decker in the Fourth Circuit: the holding that basis was not reduced by contingent deductible liabilities was affirmed, but the holding that the transaction did not lack economic substance was reversed and the case was remanded for trial.** Black & Decker Corp. v. United States, 436 F.3d 431, 2006-1 U.S.T.C. ¶50,142 (4th Cir. 2/2/06), *aff'g denial of government's motion for summary judgment at* 2004-2 U.S.T.C. ¶ 50,359 (D. Md. 8/3/04), *rev'g grant of taxpayer's motion for summary judgment at* 340 F. Supp. 2d 621 (D. Md. 10/22/04), *and remanding for trial.* Judge Michael's opinion held that the government motion for summary judgment was properly denied because the statute in effect at the time of the transaction permitted taxpayer to do what it did, stating:

> The IRS presses two arguments for why Taxpayer cannot claim the § 357(c)(3) exception. The first argument relies on legislative history. The IRS focuses on sentences such as the first of the two from the Senate Report quoted. It contends that Congress crafted the exception to protect a parent corporation from a tax double whammy when transferring both assets *and* associated liabilities to a subsidiary in exchange for stock. From this perspective, Congress wanted to prevent such parent corporations from being twice penalized by (1) deprivation of the right to deduct the transferred liabilities as they accrued and (2) mandatory reduction of the stock basis by the amount of the liabilities transferred. Since Taxpayer only transferred the health claims but not the assets generating those claims, the IRS argues that Congress did not intend for Taxpayer to benefit from § 357(c)(3). Further, the IRS reads the quoted phrase "would have given rise to a deduction," S. Rep. No. 96-498, at 62, to mean a deduction unavailable to the transferor once the liability has been transferred.
>
> The legislative history argument does not persuade us. The prototypical transaction Congress had in mind in drafting § 357(c)(3) may well have been one in which a corporation exchanged liabilities as part of a transfer of an entire trade or business to a controlled subsidiary, but nothing in the section's plain language embraces such a limitation. As a result we find no ambiguity in the statute that requires us to parse the congressional record and discern what *type* of business transactions Congress originally envisioned in enacting the section. The Senate Report's use of the phrase "would have given rise" also does not go as far as the IRS would have us take it. On the contrary, we agree with one commentator's observation that this language "does not imply . . . that Congress silently contemplated a case in which liabilities are transferred but the deduction is retained by the transferor and [then] concluded that § 357(c)(3) should not apply." Ethan Yale, *Reexamining Black & Decker's Contingent Liability Tax Shelter*, 108 Tax Notes 223, 234 (July 11, 2005).
>
> The IRS's second argument is based on sound administration of the tax laws, because the Taxpayer should not be allowed to take the "functional equivalent of a double deduction." Appellant's Br. at 59. Although Taxpayer has not claimed the employee health expenses as a deduction (BDHMI, not a party to this suit, claims them instead), the IRS argues that Taxpayer has the legal right to seek these deductions as health care costs accrue. In the IRS's view, the $ 560 million loss that Taxpayer reported effectively accelerates deductions for uncertain future health care costs through the year 2007. Such acceleration would contravene the

prohibition against claiming a deduction in a given tax year for an estimate of liabilities that have not become fixed by the end of that year. Here, receipt of medical care and filing of proper claims forms would fix the annual health care liability. *United States v. Gen. Dynamics Corp.*, 481 U.S. 239, 242-45, 107 S. Ct. 1732, 95 L. Ed. 2d 226 (1987).

Again, we are not convinced that the language of § 357(c)(3) is so unclear as to permit us to rely on this policy argument and adopt the IRS's reading. In addition, because BDHMI files a tax return separate from Taxpayer's and has been taking the deductions for the health care expenses as the expenses are incurred, the "double deduction" argument would only work if we were to treat BDHMI and Taxpayer as a single entity. We see no justification on the present record for disregarding the distinct corporate taxpayer identities of BDHMI and Taxpayer. Rather, we agree with Taxpayer: "BDHMI pays the claims; BDHMI takes the deductions - not Taxpayer." Appellee's Br. at 27.

We conclude that the contingent liability Taxpayer transferred to BDHMI falls within the § 357(c)(3) exception for "liability the payment of which . . . would give rise to a deduction." Therefore, under § 358(d)(2)'s exception to the general rule of § 358(d)(1), the liability need not be treated as "money received" by Taxpayer for basis reduction purposes. For this reason the district court's denial of the IRS's summary judgment motion was correct.

- Judge Michael held that the government was entitled to a trial on the issue of whether the transaction was a sham, stating:

The district court's approach to the objective prong strayed from our precedents. Although the district court quoted the pertinent language from *Rice's Toyota, see* 340 F. Supp. 2d at 623, it went on to assert: "A corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id.* at 623-24. In so reasoning, the district court mischaracterized the *Rice's Toyota* test, which focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute. "The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from *the transaction* existed apart from tax benefits." *Rice's Toyota*, 752 F.2d at 94 (emphasis added). Thus, many of the undisputed facts upon which the district court relied in concluding that Taxpayer was entitled to summary judgment - including the facts that BDHMI "maintained salaried employees" and paid health claims as they came due with BDHMI assets, 340 F. Supp. 2d at 624 - were simply not germane to the proper inquiry under the second prong of our circuit's sham transaction test.

We do not agree with Taxpayer's contention that the Supreme Court's decision in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S. Ct. 1132, 87 L. Ed. 1499, 1943 C.B. 1011 (1943), supports the district court's analysis of the objective prong under *Rice's Toyota*. The Court in *Moline* held that a corporate taxpayer, the petitioner, "had a tax identity distinct from its stockholder," an individual, such that gain realized on sales in two tax years were to be treated as income taxable to the corporation, not to the individual. 319 U.S. at 440. To reach this conclusion, the Court examined the purposes for the individual's establishment of the corporation. *Id.* at 439-40. The Court recognized that in some tax cases "the corporate form may be disregarded where it is a sham or unreal."

Id. at 439. *Moline* is not implicated, however, by the IRS's allegation that under the objective prong of the sham transaction test there was no reasonable profit opportunity in the two-phase transaction Taxpayer executed with BDHMI in November and December 1998. The IRS is not arguing at this point that BDHMI's corporate identity separate from Taxpayer must be disregarded for tax purposes, such that income earned by one is to be attributed to the other. Shams under *Rice's Toyota* are distinct from shams under *Moline*. In particular, a shareholder's transaction with a controlled corporation may be a sham under *Rice's Toyota* even if the corporation is entitled to regard its income as distinct from its shareholder's because the corporation is not itself a sham under *Moline*.

Hines illustrates the proper analysis under the objective prong of the *Rice's Toyota*. *Hines* involved an IRS challenge to investment interest and depreciation deductions stemming from a taxpayer's purchase and lease back to the seller of used computer equipment. We first noted that the payments on the transaction would leave the taxpayer "with a loss of $ 127,324 over the eight years of the lease" to the seller. 912 F.2d at 739. We next identified all of the possible sources of revenue on the transaction and weighed them against this loss. *See id.* at 739-40. Viewing the evidence in the light most favorable to the taxpayer, which had won at trial, we nevertheless concluded that the transaction "failed to yield any reasonable expectation of a profit." *Id.* at 739. *Hines* clarifies that under this circuit's firmly established *Rice's Toyota* standard, the objective prong of the sham transaction test focuses on reasonable expected profits from a transaction. There is no basis here for abandoning our standard by scrutinizing the transaction for its "real economic effects," despite Taxpayer's argument that we should do so based on the law of another circuit. *See United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1019 (11th Cir. 2001).

- "[I]t is not the imprecise amount of the claims that renders them nondeductible but their contingent nature. ... [S]imply because a manufacturer has provided a warranty to a consumer, the scope of which is defined to a some degree by statute, does not mean that liability has attached; until a claim has been filed invoking the terms of a warranty, liability remains contingent and, because of that fact, non-deductible."

- As illustrated by Rev. Rul. 95-74, § 357(c)(3) applies not only to cash method accounts payable, but also to liabilities of accrual method transferors that have not yet been allowed as a deduction under the economic performance rules of § 451(h) or because the liability is too contingent. As a result, § 358(d)(2) applies and the transferor shareholder's basis in the stock received in the exchange is not reduced by the liability. Aggressive tax planners took advantage of this pattern of the interaction of the various statutory provisions to create artificial double deductions.

3. **A second taxpayer victory in a listed contingent liability transaction, but reversed on appeal.** <u>Coltec Industries, Inc. v. United States</u>, 62 Fed. Cl. 716 (Fed. Cl. 10/29/04), *vacated and remanded*, 454 F.3d 1340, 2006-2 U.S.T.C. ¶50,389 (Fed. Cir. 7/12/06). Taxpayer transferred its asbestos liabilities to an asbestos case management entity ["Garrison"], which was existing shell subsidiary that had no assets, together with a related party note for $375 million and some other miscellaneous assets. It sold about 6.67 percent of the Garrison stock to two banks for a total of $500,000 and reported a multimillion dollar loss that saved it over $82 million in taxes.

a. **Court of Federal Claims opinion:** Judge Susan G. Braden found that this transaction satisfied all the requirements of existing law. Judge Braden rejected the concept of a court applying the economic substance doctrine to tax cases on the ground that taxpayers "must be able to rely on clear and understandable rules established by Congress to ascertain their federal tax obligations." After discussing the complexity of the economic substance doctrine, she concluded "that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers.

- As illustrated by Rev. Rul. 95-74, 1995-2 C.B. 36, § 357(c)(3) applies not only to cash method accounts payable, but also to liabilities of accrual method transferors that have not yet been allowed as a deduction under the economic performance rules of § 461(h) or because the liability is too contingent. As a result, § 358(d)(2) applies and the transferor shareholder's basis in the stock received in the exchange is not reduced by the liability. Aggressive tax planners took advantage of this pattern of the interaction of the various statutory provisions to create artificial double deductions. Here, in a transaction subject to § 351 one corporation, Garlock, contributed to another corporation, Garrison, cash, a $375 million promissory note to Garlock from a related corporation, and certain other property. In connection with the transfer Garrison assumed $371.2 million of Garlock's contingent liabilities for asbestos product liability damage claims (neither of the events necessary to establish the fact of the liability had occurred, i.e., the filing of a lawsuit asserting a claim and an adjudication of liability). Shortly thereafter, Garlock sold a significant number of the shares of Garrison and claimed approximately $370 million of losses, having determined the basis of the Garrison stock with reference to an exchanged basis under § 358 that was not reduced to reflect the assumption of the contingent asbestos liabilities. Since the liabilities were contingent and the liabilities would have been deductible by the transferor upon payment, the court held that the liabilities were within those described in §§ 357(c)(3)(A) and 358(d)(2), and thus neither § 357(c)(1), requiring the recognition of gain to the extent that the amount of liabilities exceed the basis of the contributed assets, nor § 358(d)(1), requiring the reduction of the transferred basis assigned to the stock, applied. Therefore, Garlock's basis in Garrison properly was the exchanged based of the transferred property, unreduced by the amount of liabilities assumed by Garrison, and the loss was allowed.

b. **Federal Circuit opinion: Taxpayer is hung out to dry by the Federal Circuit on the economic substance issue.** The court (Judge Dyk) first found that the loss was allowable under the literal terms of the statute as it existed at the time of the transaction because (1) the liabilities fell within § 357(c)(3), (2) § 357(b)(1) was not relevant, and (3) § 358(d)(2) excluded the liabilities from "money received," so that the basis of the company's stock was increased by the note and was not reduced by the assumed contingent asbestos liabilities. However, Judge Dyk further found that the transaction that gave rise to the alleged tax benefit, which he narrowed down to say that the transfer of the $375 million note to Garrison in exchange for the assumption of the contingent asbestos liabilities, had no meaningful economic purpose except the tax benefits to Coltec and, therefore, "must be ignored for tax purposes."

- In finding lack of economic substance, Judge Dyk adopted an objective view of the transaction, in which he found that the transfer of the asbestos liabilities to a subsidiary would not affect Coltec's obligation to pay them and had no effect on third party asbestos claimants. He also held that the Fourth Circuit's disjunctive test for application of the economic substance doctrine, that it must both have the subjective motivation of tax avoidance and lack the objective motivation of business purpose [i.e., a reasonable possibility of pre-tax profit], was inapplicable and that the law of the Federal Circuit was changed to require that taxpayer meet both prongs to pass the economic substance test. Two of the cases upon which Judge Dyk relied were *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), and *UPS v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

4. **The Second Circuit reverses a taxpayer victory in a self-liquidating partnership note transaction, in which the lion's share of income was allocated to a tax-indifferent party, on the ground that the tax-indifferent Dutch banks were not really equity partners.** TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 11/1/04), *rev'd*, 459 F.3d 220 (2d Cir. 8/3/06) ("Castle Harbour").

a. **District court opinion:** The court found that the creation of Castle Harbour, a Nevada LLC, by General Electric Capital Corp. subsidiaries was not designed solely to avoid taxes, but to spread the risk of their investment in fully-depreciated commercial airplanes used in their leasing operations. GECC subsidiaries put the following assets into Castle Harbor: $530 million worth of fully-depreciated aircraft subject to a $258 million non-recourse debt, $22 million of rents receivable, $296 million of cash, and all the stock of another GECC subsidiary that had a value of $0. Two tax-indifferent Dutch Banks invested $117.5 million in Castle Harbour Under the LLC agreement, the tax-indifferent partner was allocated 98 percent of the book income and 98 percent of the tax income.

- The book income was net of depreciation and the tax income did not take depreciation into account [because the airplanes were fully depreciated]. Depreciation deductions for book purposes were on the order of 60 percent of the rental income for any given year.

- Scheduled distributions in excess of book income would have resulted in the liquidation of the investment of the Dutch banks in eight years, with the Dutch banks receiving a return of approximately nine percent, with some "economically substantial" upside and some downside risk. Castle Harbour was terminated after five years because of a threatened change in U.S. tax law, but during that period about $310 million of income was shifted to the Dutch banks for a tax saving to the GECC subsidiaries of about $62 million.

- Query whether § 704(b) was properly applied to this transaction?

- This appears to be a lease-stripping transaction in which the income from the lease was assigned to foreign entities while the benefits of ownership were left with a domestic entity.

- The court (Judge Underhill) held that satisfaction of the mechanical rules of the regulations under § 704(b) transcended both an intent to avoid tax and the avoidance of significant tax through agreed upon partnership allocations. In this partnership, 2 percent of both operating and taxable income was allocated to GECC, a United States partner, and 98 percent of both book and taxable income was allocated to partners who were Dutch banks. The Dutch banks were foreign partners who were not liable for United States taxes and thus were indifferent to the U.S. tax consequences of their participation in the partnership. Because the partnership had very large book depreciation deductions and no tax depreciation, most of the partnership's taxable operating income, which was substantially in excess of book taxable income, was allocated to the tax-indifferent foreign partners, even though a large portion of the cash receipts reflected in that income was devoted to repaying the principal of loans secured by property that GECC had contributed to the partnership. The overall partnership transaction saved GECC approximately $62 million in income taxes, and the court found that "it appears likely that one of GECC's principal motivations in entering into this transaction – though certainly not its only motivation – was to avoid that substantial tax burden." The court understood the effects of the allocations and concluded that "by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch Banks, GECC avoided an enormous tax burden, while shifting very little book income. Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to "re-depreciate" the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation." Nevertheless, the court upheld the allocations. "The tax benefits of the *** transaction were the result of the allocation of large amounts of book income to a tax-neutral entity, offset by a large depreciation expense, with a corresponding allocation of a large amount of taxable income, but no corresponding allocation of depreciation deductions. This resulted in an enormous tax savings, but the simple allocation of a large percentage of income violates no rule. The government does not – and cannot – dispute that partners may allocate their partnership's income as they choose. Neither does the government dispute that the taxable income allocated to the Dutch Banks could not be offset by the allocation of non-existent depreciation deductions to the banks. And *** the bare allocation of a large interest in income does not violate the overall tax effect rule."

- Judge Underhill concluded:

> The government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some $ 62 million in tax revenue. Moreover, it appears likely that one of GECC's principal motivations in entering into this transaction - though certainly not its only motivation - was to avoid that substantial tax burden. Nevertheless, the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose; the transaction resulted in the creation of a true partnership with all participants holding valid partnership interests; and the income was allocated among the partners in accordance with the Internal Revenue Code and Treasury Regulations. In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.

b. **Second Circuit opinion:** The Second Circuit, in an opinion by Judge Leval, held that the Dutch banks were not partners because their risks and rewards were closer to those of creditors than partners. He used the facts-and-circumstances test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine whether the banks' interest was more in the nature of debt or equity, and found that their interest was overwhelmingly in the nature of a secured lender's interest, "which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits."

- In *ACM* [Colgate], Judge Laro wrote a 100+ page analysis to find that there was no economic substance to the arrangement. The next contingent payment installment sale case in the Tax Court was *ASA Investerings* [Allied Signal], in which Judge Foley wrote a much shorter opinion finding that the Dutch bank was not a partner; the D.C. Circuit affirmed on Judge Foley's holding that the Dutch bank was not a partner. The IRS began to pick up this lack-of-partnership argument and began to use it on examinations. Later, the Tax Court (Judge Nims) used the economic substance argument in *Saba* [Brunswick], which the DC Circuit remanded based on *ASA Investerings* to give taxpayer the opportunity to argue that there was a valid partnership [which it could not do, as Judge Nims found on remand]. Even later, the D.C. Circuit reversed the District Court's *Boca* [Wyeth, or American Home Products] case based upon this lack-of-partnership argument – even though Cravath planned *Boca* carefully so that if the Dutch bank was knocked out, there would still be a partnership – based upon its *ASA Investerings* and *Saba* findings on appeal that there was no partnership. Now we have Judge Leval of the Second Circuit adopting the lack-of-partnership argument that Judge Foley used allegedly because he was unwilling to perform the full-fledged economic analysis necessary to find a lack of economic substance.

5. **A District Court finds for the taxpayer in a COLI case in an incredible opinion.** Dow Chemical Co. v. United States, 250 F. Supp. 2d 748, 2003-1 U.S.T.C. ¶50,346, 91 A.F.T.R.2d 2003-1489 (E.D. Mich. 3/31/03). In a carefully-detailed opinion Judge Lawson finds that Dow did correctly almost everything that Camelot and AEP did incorrectly. The interest rate on policy loans was not unreasonably high, and a positive pre-tax cash flow was expected. The court found that there was a business purpose for the COLI arrangements, i.e., to provide retiree benefits. The premiums for the first three years were payable with policy loans and the premiums for years four through seven were payable 90% with partial [cash] withdrawals (from policies whose cash value had been previously borrowed) and 10% with cash from the taxpayer. Judge Lawson found that the partial withdrawals were "shams in fact" because there was no cash value left in the policies to borrow, but that the § 264(c)(1) test was met because of the payments of 10% of the premiums by taxpayer with its own cash in years four through seven. The court found that the § 264(c)(1) safe harbor did not require level premiums over the first seven years and that the "premium" for each of years four to seven was the 10% paid in cash. Judge Lawson found that Reg. § 1.264-4(c)(1)(ii) (which required level premiums) was invalid, and he rejected the holding in both *CM Holdings* and *AEP* that the four-out-of-seven test required level premiums.

- In finding that taxpayer expected a positive pre-tax cash flow, Judge Lawson refused to admit into evidence a statement in taxpayer's protest that could have led to a contrary conclusion on the ground that Rule 408 of the Federal Rules of Evidence provides that statements made during settlement negotiations are inadmissible at trial.

a. **There's no harm in asking? Not from asking Judge Lawson!** Dow Chemical Co. v. United States, 278 F. Supp. 2d 844, 2003-2 U.S.T.C ¶50,681 (E.D. Mich. 8/12/03). The government's motion to amend the court's judgment was granted in part and denied in part, but left intact the same judgment and basic result. Ironically, since the motion opened up all findings of fact, Judge Lawson reversed his earlier finding that the partial withdrawals in years four through seven were "shams in fact," thus making moot the government's argument relating to the logical consequences of this earlier finding, i.e., that taxpayer did not meet the four-of-seven test because it did not pay the entire premium in each of years four through seven from its own funds.

b. ***Dow* is reversed by the Sixth Circuit.** Dow Chemical Co. v. United States, 435 F.3d 594, 2006-1 U.S.T.C. ¶50,126 (6th Cir. 1/23/06) (2-1), *petition for cert. filed*, 10/6/06. The Sixth Circuit reversed and held that the Dow COLI plans were "economic shams" because there was little likelihood that Dow would make substantial cash infusions in the future, so the pre-tax cash flows would at all times be negative, following *Knetsch v. United States*, 364 U.S. 361 (1960). This holding eliminates the court's need to decide the proper discount rate, as well as issue of the exclusion of Dow's tax protest letters under Rule 408 of the

Federal Rules of Evidence [inadmissibility of statements made during settlement negotiations]. The court further held that there would be little or no inside build-up and that Dow's possible mortality gains were limited under the plans.

- Judge Ryan dissented on the ground that the majority opinion improperly read *Knetsch* to hold as "a general principle of law that future profits are not even relevant to the economic substance inquiry when the taxpayer's projected future investment in a particular plan is greater than its past investment in the plan, regardless whether the projected future investment is feasible and there is evidence that it is likely to occur"; instead, Judge Ryan states that *Knetch* indicated only that the Court made a credibility assessment and determined that Mr. Knetsch did not intend to make the $4 million future investment necessary to pay off the loan. Judge Ryan would also have found that the Dow plans transferred mortality risk to the insurers so mortality gains were possible.

6. **Sale vs. reorganization? Reverse subsidiary reorganization treatment denied because target's parent received boot in excess of 20 percent; the boot consisted of its being appointed the non-equity manager of an LLC which contained cash in the amount of $1.375 billion.** Tribune Company v. Commissioner, 125 T.C. No. 8 (9/27/05), *as amended*, (10/13/05). In this attempted reverse triangular merger, taxpayer's predecessor, the Times Mirror Co. ("TM") wanted to divest its low-basis Matthew Bender subsidiary ("MB"). TM was represented by E&Y, Gibson, Dunn & Crutcher, and Goldman Sachs. Reed Elsevier ("Reed") was interested in acquiring MB and was willing to pay $1.375 billion to make the acquisition. Reed was represented by Price Waterhouse. In the transaction, Reed subsidiaries organized a special-purpose corporation, MB Parent, and held relatively low value, nonparticipating preferred stock with 80 percent control. MB Parent, in turn owns preferred stock and nonvoting common stock in an acquisition subsidiary that will merge with MB, as well as a nonvoting interest in a single member LLC that holds the $1.375 billion of cash. As a result of the merger of MB into the acquisition subsidiary, TM will own all the common stock and the remaining 20 percent voting power of MB Parent. Even though, TM will not have voting control over MB Parent, it will control the LLC by virtue of being the sole (nonequity) manager of the LLC.

- The plan was for the merger of MB into the acquisition subsidiary in exchange for MB Parent common and preferred stock to qualify as a tax free reverse subsidiary merger under § 368(a)(2)(E). At some later date, by mutual agreement, the MB and MB Parent preferred stock could be redeemed at face value and the nonvoting common could be redeemed at a formula price, which would leave Reed as the sole owner of MB and TM as the sole owner of MB Parent. At that point, TM would have the ability to liquidate MB Parent and the LLC without a tax cost.

- The Tax Court (Judge Cohen) held that TM received both common stock in MB Parent and the management authority over the LLC, which had to be valued separately. Inasmuch as the MB Parent common stock lacked control over any assets, it was worth far less than $1.1 billion [80 percent of $1.375 billion], and the transaction failed to qualify as a reorganization under § 368(a)(2)(E). Moreover, it did not qualify as a "B" reorganization because TM received consideration other than stock, i.e., the management authority over the LLC. Judge Cohen based her conclusion on the facts that TM intended a sale and that MB Parent serves no purpose and performs no function apart from TM's attempt to secure the desired tax consequences.

7. **Tax avoidance scheme works in the Court of Federal Claims.** Principal Life Insurance Company v. United States, 70 Fed. Cl. 144 (3/17/06). The court (Judge Allegra)

upheld a transaction structured to eliminate the § 453A interest charge on the deferred tax liability for the gain to be recognized on about $478 million of installment notes held by each of taxpayer and Prudential Life Insurance Company. These installment notes (arising from a sale of commercial mortgages to one another) were in turn sold to wholly-owned consolidated subsidiaries in order to trigger gain recognition under § 453B(a)(1) and eliminate the interest charge while the triggered gain was deferred under [pre-1991] Reg. § 1.1502-13. Judge Allegra held that the sale of the notes to the consolidated subsidiary was bona fide, and was not a capital contribution under § 351 because "while [the subsidiary] might be viewed as thinly capitalized, there is no indication that it was inadequately capitalized," following *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). The one non-tax purpose found by the court for using taxpayer's subsidiary to hold the Prudential installment notes was as a so-called "bankruptcy-remote entity" often used in securitized lending to lessen the likelihood that a bankruptcy court will order a substantive consolidation of an insolvent parent with a solvent subsidiary.

8. **District Court upholds BLIPS tax shelter on taxpayer's partial summary judgment motion.** Klamath Strategic Investment Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 7/20/06). The court (Judge Ward) held that the premium portion of the loans received from the bank in connection with the funding of the instruments contributed to the partnership was a contingent obligation, and not a fixed and determined liability for purposes of § 752. He further held that a recently adopted regulation to the contrary was not retroactive, and was therefore invalid as applied to these transactions.

a. **Fighting duplication and acceleration of losses through partnerships before June 24, 2003.** T.D. 9062, Assumption of Partner Liabilities, 68 F.R. 37414 (6/24/03). Temp. Reg. § 1.752-6T provides rules, similar to the rules applicable to corporations in § 358(h), to prevent the duplication and acceleration of loss through the assumption by a partnership of a liability of a partner in a nonrecognition transaction. Under the temporary regulations, if a partnership assumes a liability, as defined in § 358(h)(3), of a partner (other than a liability to which § 752(a) and (b) apply) in a § 721 transaction, after application of §§ 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount of the liability. For this purpose, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for Federal tax purposes. Reduction of a partner's basis generally is not required if: (1) the trade or business with which the liability is associated is transferred to the partnership, or (2) substantially all of the assets with which the liability is associated are contributed to the partnership. However, the exception for contributions of substantially all of the assets does not apply to a transaction described in Notice 2000-44, 2000-2 C.B. 255 (or a substantially similar transaction).

- The temporary regulations are effective for transactions occurring after 10/18/99 and before 6/24/03.

b. **Defining the term "liability" in § 752 and fighting duplication and acceleration of losses through partnerships after June 24, 2003.** REG-106736-00, Assumption of Partner Liabilities, 68 F.R. 37434 (6/24/03). The Treasury has proposed extraordinarily complex, verging on incomprehensible, regulations: (1) defining liabilities under § 752; (2) dealing with a partnership's assumption of certain fixed and contingent obligations in exchange for a partnership interest [Prop. Reg. § 1.752-7]; and (3) providing rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships [Prop. Reg. § 1.358-

7]. Reg. § 1.752-1(a)(1)(i) would be amended to include the principles of Rev. Rul. 88-77, 1988-2 C.B. 128; an obligation is a liability to the extent that incurring the obligation: (1) creates or increases the basis of any of the obligor's assets (including cash); (2) gives rise to an immediate deduction; or (3) gives rise to an expense that is not deductible in computing taxable income and is not properly chargeable to capital. Prop. Reg. § 1.752-7 deals with the assumption by a partnership of a partner's fixed or contingent obligation to make payment that is not one of the three types described in Reg. § 1.752-1(a)(1)(i) [including accrual method liabilities the deduction for which was deferred under § 453(h)]. Unlike Temp. Reg. § 1.752-6T, the proposed regulations do not reduce the partner's outside basis when the partnership assumes a § 1.752-7 liability. If the partnership satisfies the liability while the partner remains in the partnership, the deduction with respect to the built-in loss associated with the § 1.752-7 liability is allocated to the partner, reducing that partner's outside basis. Alternatively, if one of three events occurs that separate the partner from the, then the partner's outside basis is reduced immediately before the occurrence of the event. The events are: (1) a disposition (or partial disposition) of the partnership interest by the partner, (2) a liquidation of the partner's partnership interest, and (3) the assumption (or partial assumption) of the liability by another partner. The basis reduction generally is the lesser of (1) the excess of the partner's basis in the partnership interest over the adjusted value of the interest, or (2) the remaining built-in loss associated with the liability. (In the event of a partial disposition, the reduction is pro rated.) Thereafter, to the extent of the remaining built-in loss associated with the liability, the partnership (or the assuming partner) is not entitled to any deduction or capital expense upon satisfaction (or economic performance) of the liability, but if the partnership notifies the partner, the partner is entitled to a loss or deduction. If another partner assumed the liability, the partnership must immediately reduce the basis of its assets by the built-in loss, and upon satisfaction, the assuming partner must make certain basis adjustments to his partnership interest. There are exceptions for (1) transfer of the trade or business with which the liability is associated is transferred to the partnership, and (2) *de minimis* transactions (liabilities less that 10 percent of the partnership's assets or $1,000,000). Unlike under the Temporary regulations, there is no exception for transactions in which substantially all of the assets with which the liability is associated are contributed to the partnership. When finalized, the regulations will be effective for transactions occurring after 6/24/03.

c. **Finally, final regulations.** T.D. 9207, Assumption of Partner Liabilities, 70 F.R. 30334 (5/26/05). Final and temporary regulations on a partnership's assumption of certain fixed and contingent obligations in connection with the issuance of a partnership interest. The regulations also provide rules under § 358(h) for assumptions of liabilities by corporations from partners and partnerships. There are also temporary regulations that provide additional rules under § 358(h) for assumptions of liabilities in pre-6/24/03 exchanges.

- The regulations ensure that tax losses cannot be duplicated or accelerated by transferring contingent obligations to partnerships.

- They also make final temporary regulations that address the "Son of Boss" tax shelter, § 1.752-6T [which were effective 10/19/99]; these provide that the exception contained in § 358(h)(2)(B) [where substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange] do not apply to transactions described in Notice 2000-44, 2000-2 C.B. 255.

(1) REG-106736-00, 70 F.R. 30380 (5/26/05). Proposed regulations that are identical to the temporary regulations contained in T.D. 9207.

9. Transcapital Leasing Associates 1990-II, L.P. v. United States, 97 AFTR2d 2006-1916 (W.D. Tex. 3/31/06). In a complex mainframe computer leasing transaction, the taxpayer essentially received over $11,000,000 in tax deductions without any corresponding income or economic loss in consideration of a $559,947 fee; the 20:1 tax write-off was "an artificial creation of a tax avoidance structure that bifurcated 'phantom' income from 'phantom' loss." The court applied a sham transaction analysis to find that the taxpayer "had no legitimate business purpose other than tax avoidance for entering into the [leasing transaction] and there was no reasonable expectation of profit. ... The ... transaction [was] solely shaped by tax avoidance objectives and completely lacking in profit potential."

B. Identified "tax avoidance transactions."

1. **Transactions involving significant book-tax differences are removed from the list of reportable transactions because they are covered by Schedule M-3.** Notice 2006-6, 2006-5 I.R.B. 385 (1/6/06). Transactions involving significant book-tax differences are removed from the list of reportable transactions.

2. **Accrual over the term of the notional principal contract of the noncontingent component of the nonperiodic payment to be received at the end of the term is required.** Rev. Rul. 2002-30, 2002-21 I.R.B. 971 (5/6/02). When a notional principal contract provides for payment comprised of noncontingent and contingent components, the appropriate method for the inclusion into income or deduction of the noncontingent component of the nonperiodic payment is over the term of the NPC. Interest must also be accounted for in a manner consistent with Reg. §§ 1.446-3(f)(2) (ii) or (iii), and 1.446-3(g)(4).

- Taxpayer agrees to make quarterly payments to counterparty based on the three-month LIBOR multiplied by a notional principal amount of $100,000,000. In return, at the end of 18 months, the counterparty will pay taxpayer 6 percent per year multiplied by a notional principal amount of $92,000,000 [or, $8,280,000], and, in addition, the counterparty will either pay taxpayer $8 million times the percentage increase in the stock index, or taxpayer will pay the counterparty $8 million times the percentage decrease in the stock index. The ruling holds that, to offset the taxpayer's deductible quarterly payments, the taxpayer must ratably accrue over the 18-month term the $8,280,000 that taxpayer will receive from the counterparty at the end of the term.

a. **An arrangement similar to that of Rev. Rul. 2002-30 is identified as a listed tax shelter.** Notice 2002-35, 2002-21 I.R.B. 992 (5/6/02). The transaction in this notice involves the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer, while disregarding the accrual of a right to receive offsetting payments in the future. Under the NPC, taxpayer is required to make periodic payments to a counterparty at regular intervals of one year or less based on a fixed or floating rate index. In return, the counterparty is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison the contingent component, may be based upon a fixed or floating interest rate; the contingent component may reflect changes in the value of a stock index or currency.

- This transaction may be entered into without any initial cash investment by the taxpayer. The counterparty may lend the money to the taxpayer, who pays it back in installments as purportedly deductible payments. The taxpayer may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction.

- Taxpayer seeks to deduct the ratable daily portion of each periodic payment to which that portion relates, but taxpayer does not accrue income with respect to the nonperiodic payment until the year the payment is received.

- The proper treatment of the payments is that the nonperiodic payment to be received by the taxpayer at the end of the term of the NPC must be accrued ratably over the term of the NPC, as set forth in Rev. Rul. 2002-30.

- Transactions that are the same as, or substantially similar to, the transaction described are identified as "listed transactions" for purposes of Temp. Reg. §§ 1.6011-4T(b)(2) and 301.6011-2T(b)(2).

b. **Certain notional principal contracts are no longer listed transactions.** Notice 2006-16, 2006-9 I.R.B. 538 (2/13/06), *clarifying and modifying* Notice 2002-35, 2002-21 I.R.B. 992.

> This notice clarifies Notice 2002-35, 2002-1 C.B. 992, by illustrating certain transactions that are not the same as or substantially similar to the transaction described in Notice 2002-35, and thus are not "listed transactions" ***
>
> This notice responds to concerns expressed by commentators that the difficulty in identifying transactions that are the same as or substantially similar to the transaction described in Notice 2002-35 has caused taxpayers to file large numbers of disclosure statements on Form 8886, *Reportable Transaction Disclosure Statement*, for common transactions, such as total return swaps, that are entered into for *bona fide* non-tax purposes. This notice is intended to narrow the scope of reportable transactions that might be perceived to be substantially similar to the transaction described in Notice 2002-35, and is intended to reduce the number of Form 8886 filings. This notice should not be construed as expanding the scope or potential application of Notice 2002-35 in any way. Specifically, no inference is intended regarding whether transactions not described in Section 3.01 are or are not required to be reported under Notice 2002-35.
>
> SECTION 3. DISCUSSION *.01 Transactions Excluded from the Scope of Notice 2002-35.* An NPC that requires a counterparty to make a contingent nonperiodic payment, whether or not the nonperiodic payment consists of contingent and noncontingent components, is not a "listed transaction" for purposes of §§ 6111 and 6112, or for purposes of § 1.6011-4(b)(2), by reason of being the same as or substantially similar to the transaction described in Notice 2002-35 if: (a) The taxpayer uses a method of accounting for the NPC that takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method; (b) The taxpayer properly accounts for the NPC under § 475 of the Code; (c) The taxpayer properly accounts for the NPC under § 1.446-4; (d) The taxpayer properly accounts for the NPC as a § 1.988-5(a) hedge in connection with a qualified hedging transaction; or (e) The taxpayer properly accounts for the NPC under §1.988-2(e) (including the application of § 1.446-3(g)(4) as appropriate).

C. **Disclosure and Settlement**

1. **The Big Four settle with the IRS on tax shelters.** Deloitte settled with the IRS and agreed to a penalty to be determined after the IRS settled with the other three.

a. **The PwC deal.** IR-2002-82 (6/27/02). The IRS announced in a news release that it cut a deal with PricewaterhouseCoopers (PwC) "to resolve tax shelter registration and list maintenance issues. The IRS news release, which is similar to one issued last August regarding Merrill Lynch, says that without admitting or denying liability, PwC has agreed to make a 'substantial payment' to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995. Under the agreement, PwC will provide to the IRS certain client information in response to summonses. It will also work with the IRS to develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements, according to the release."

b. **The EY deal.** IR-2003-84 (7/2/03). The IRS announced in a news release that it has settled Ernst & Young's potential liability under the tax shelter registration and list maintenance penalty provisions for a nondeductible payment of $15 million. See 2003 TNT 128-1.

c. **The KPMG deal: the price of settling goes up dramatically.** IR-2005-83 (8/29/05). The IRS and the Justice Department announced in a news release that KPMG LLP has admitted to criminal wrongdoing and agreed to pay $456 million in fines, restitution and penalties as part of an agreement to defer prosecution of the firm. Nineteen individuals, chiefly former KPMG partners including the former deputy chairman of the firm [Jeffrey Stein], as well as a New York lawyer [R.J. Ruble] were indicted in the Southern District of New York in relation to the "multi-billion dollar criminal tax fraud conspiracy"; several of those indicted were partners in KPMG's Washington National Tax group.

d. **Judge Kaplan refuses to find prosecutorial misconduct in the deferred prosecution agreement.** United States v. Stein, 428 F. Supp. 2d 138 (S.D.N.Y. 4/4/06), *as corrected* 4/5/06. Judge Kaplan denies a motion to dismiss based upon alleged prosecutorial misconduct by reason of its alleged manipulation of KPMG in the deferred prosecution agreement. This DPA which required the firm "upon pain of corporate death, [to] espouse a government-approved version of [the] facts." Judge Kaplan based his decision on the ethical provision applicable to all attorneys that prohibits them from coercing witnesses to give false testimony. He further held that nothing in the DPA pressures individual KPMG employees to testify in any particular way, but that the DPA merely requires the firm to disavow any assertion by an affiliated individual that is inconsistent with the DPA's Statement of Facts.

e. **Judge Kaplan finds prosecutorial misconduct in the use of the Thompson Memorandum to prevent KPMG from continuing its customary practice of paying attorney's fees for individuals caught up in controversy by reason of their affiliation with the firm.** United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 6/26/06), *as amended*, 7/14/06. The court held that the Justice Department's Thompson Memorandum policy [continued from the Holder Memorandum] of basing a determination of whether a firm is "cooperating" with the government on its refusal (unless compelled by law) to advance legal fees for affiliated individuals unless they in turn fully cooperated with the government, as it was applied by the prosecutors in this case, was an unconstitutional interference with defendants' ability to use resources that –absent the government's misconduct – would be otherwise available to them for payment of attorneys' fees. The resources in question were funds that would have customarily been received by these defendants from KPMG to pay their attorneys.

- Judge Kaplan subsequently refused to eliminate from his opinion a statement that prosecutors in the case were "economical with the truth." He also refused to eliminate from his opinion the names of the prosecutors involved. 2006 TNT 130-10.

2. **Is this really the last chance global settlement initiative?** Announcement 2005-80, 2005-46 I.R.B. 967 (11/14/05). Settlement initiative for 21 transactions, not all of them listed as "abusive tax shelters," together with the accuracy-related penalty that will be imposed [varying from 5% and 20%] unless the transaction was disclosed under Announcement 2002-2, 2002-1 C.B. 304, or the taxpayer relied upon a more-likely-than-not opinion from a non-disqualified tax advisor that considered all the relevant facts and did not assume any unreasonable facts. The terms of the settlement require that improperly-claimed tax benefits be disallowed, but transaction costs will generally be allowed as an ordinary loss. Promoters and related persons are not normally eligible for the settlement initiative, and persons engaged in a transaction that had been designated for litigation, persons in litigation, persons against whom the fraud penalty was imposed or considered and persons under criminal investigation are ineligible for the settlement initiative. Taxpayers must notify the IRS of their intent to participate by 1/23/06 by making an election on Form 13750 ("Election to Participate in Announcement 2005-80 Settlement Initiative"), and sending it, together with all required attachments, to the Service.

a. **Frequently Asked Questions** ("FAQs") on the Announcement 2005-80 Settlement Initiative (Rev. 12/12/05), 2005 TNT 239-8 and the IRS web site. Son of Boss transactions are ineligible for the settlement initiative.

b. **Strong encouragement for taxpayers to use the Announcement 2005-80 global settlement initiative.** Section 303 of the **GO Zone Act of 2005** amends § 903 of the **Jobs Act of 2004** to provide that the Code § 6404(g) post-18-month interest suspension will not apply at all to reportable and listed transactions that are still open on 12/14/05 unless the taxpayer is participating in a settlement initiative described in Announcement 2005-80 or the IRS has determined that the taxpayer "has acted reasonably and in good faith." Section 903 of the **Jobs Act of 2004** provided that the interest suspension for reportable and listed transactions would not apply after 10/3/04.

3. **Proposed Circular 230 changes that do not relate to tax shelters are nevertheless controversial, what with new restrictions on the use of contingent fees, monetary penalties for practitioners and their firms, and public hearings before ALJs.** REG-122380-02, Regulations Governing Practice Before the Internal Revenue Service, 71 F.R. 6421 (2/3/06). Proposed regulations issued based upon consideration of comments received in response to questions posed in an advance notice of proposed rulemaking (ANPRM) at 67 F.R. 77724 (12/19/02), as well as amendments made to 31 U.S.C. § 330 by the American Jobs Creation Act of 2004. Changes include: (1) changing references to the office of the Director of Practice to the Office of Professional Responsibility; (2) adding to the definition of "practice before the [IRS]" in § 10.2(d) "rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion"; (3) revoking the authorization of an unenrolled return preparer to represent a taxpayer during an examination of a return that he or she prepared; (4) eliminating the ability of a practitioner to charge a contingent fee for services rendered in connection with the preparation or filing of an amended tax return or claim for refund or credit, although contingent fees are permissible for services rendered in connection with the IRS's examination of, or challenge to,

an amended return or claim for refund or credit filed prior to the taxpayer receiving notice of the examination of, or challenge to the original tax return, § 10.27; (5) adding to the standards applicable with respect to tax return positions in§ 10.34, the requirement that a practitioner may not advise a client to submit "a document, affidavit or other paper ... to the [IRS]" if (a) its purpose is to delay or impede the administration of the Federal tax laws,(b) it is frivolous pr groundless, or (c) it contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation; (6) adding to the sanctions in § 10.50 the authority to impose a monetary penalty on the practitioner who engages in conduct subject to sanction, as well as the authority to impose a monetary penalty on the "employer, firm or entity" of a practitioner acting on its behalf provided that the employer, firm or entity knew of reasonable should have known of such conduct; and (7) modifying the definition of disreputable conduct in § 10.51 to include willful failure to sign a tax return the practitioner prepared or unauthorized disclosure of returns or return information.

- The most controversial proposed change is a provision in § 10.72(d) that all hearings, reports, evidence and decisions in a disciplinary proceeding be available for public inspection, with protection of the identities of any third party taxpayers contained in returns and return information for use in the hearing.

4. **Warm-up the photocopier for those tax accrual workpapers.** Announcement 2002-63, 2002-27 I.R.B. 72 (7/8/02). In auditing returns filed after 7/1/02 that claim any tax benefits from a "listed transaction," see Notice 2001-51, 2001-34 I.R.B. 190, the IRS may request tax accrual workpapers. Listed transactions will be determined "at the time of the request." Neither the attorney client privilege nor the § 7525 tax practitioner privilege protects the confidentiality of the workpapers.

a. **Specific procedures regarding requests for tax accrual workpapers.** Chief Counsel Notice CC-2003-012 (4/9/03). Procedures to be used regarding requests for tax accrual and other financial audit workpapers.

b. **The definition of "tax accrual workpapers" is clarified.** Chief Counsel Notice CC-2004-010 (1/22/04), *supplementing* CC-2003-012. The general definition is as follows:

> Tax accrual workpapers are those audit workpapers, whether prepared by the taxpayer or by an independent accountant, relating to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax liabilities on audit financial statements. They reflect an estimate of a company's tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.

- Documents created prior to or outside of the consideration of whether reserves should be created are not within the definition tax accrual workpapers nor are workpapers reconciling book and tax income, but they both "likely fall within the scope of the general IDRs issued at the beginning of an examination and should be produced ... even though no request for the tax accrual workpapers has been made."

c. **The government seeks summons enforcement for Textron's tax accrual workpapers.** United States v. Textron, Inc., 2006 TNT 84-19 (D. R.I. 4/28/06). In its supporting brief, 2006 TNT 84-4, the government argued that all tax accrual workpapers should be disclosed because Textron engaged in several listed transactions, specifically, six separate sale-in, lease-out ("SILO") transactions in 2001, which were designated as listed transactions in Notice 2005-13, 2005-9 I.R.B. 630.

- *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), which held that tax accrual workpapers to be available to the government because they were relevant to a legitimate IRS inquiry, is strongly supportive of the government's position. Taxpayer may rely upon the work product doctrine for protection because the tax accrual workpapers clearly are not covered by the attorney-client privilege.

5. **The work product doctrine works in the Sixth Circuit.** United States v. Roxworthy (Yum! Brands, Inc.), 457 F.3d 590 (6th Cir. 8/10/06). In response to IRS informal document request, Yum claimed that seven documents were protected by the work product doctrine. It turned over five of the documents under a limitation of waiver agreement but refused to turn over the remaining two documents, which were memoranda both dated 3/29/00 prepared by KPMG that analyzed the tax consequences of stock transfers made in connection with the creation of a captive insurance company, which involved a loss of $112 million for tax purposes, but not book purposes. On summons enforcement, the magistrate and district court ordered the documents produced, but the Sixth Circuit (Judge Cole) held that the two memoranda were protected work product because they included they were prepared in anticipation of litigation and included "possible arguments that the IRS could mount against Yum's chosen tax treatment of the transactions and possible counter-arguments."

- The court stated, :

> [I]n United States v. Adlman, 68 F.3d 1495, 1496 (2d Cir. 1995) (Adlman I), an accounting firm prepared documents evaluating the tax consequences and likely IRS challenges to a company's proposed reorganization in which the company would claim a capital loss of $ 290 million. The Second Circuit held that the district court erred in concluding that the prospect of litigation was too remote for work-product privilege to apply, observing that "[i]n many instances, the expected litigation is quite concrete, notwithstanding that the events giving rise to it have not yet occurred." Id. At 1501. The court remanded the matter for the district court to apply the proper standard.

- The standard test to be used to establish whether documents were prepared "in anticipation of litigation" is the question of whether the "documents can be said to have been created because of the prospect of litigation" (the "because of" test) – as opposed to whether they would have been prepared in substantially the same form in the absence of prospective litigation. In applying the test, the court is to ask "(1) whether a document was created because of a party's subjective anticipation of litigation, as contrasted with an ordinary business purpose, and (2) whether that subjective anticipation of litigation was objectively reasonable."

- The court noted that the reason for the requesting party to seek such documents is usually to see the "[tax professionals'] assessment of the [transaction's] legal vulnerabilities, in order to make sure it does not miss anything in crafting its legal case," which it noted was precisely the type of discovery protected by the work product doctrine.

- The court rejected the IRS argument that the memoranda were not prepared in anticipation of litigation, but "were more likely prepared to assist Yum in the preparation of its taxes and the avoidance of understatement penalties if the IRS disagreed with Yum's tax treatment . . . ."

• The court finally held that the fact that the memoranda bore an attorney-client privilege designation, not a work-product designation, should not alone settle the inquiry as to whether they were prepared in anticipation of litigation.

D. **Tax Shelter Penalties, etc.**

1. United States v. Gleason, 94 A.F.T.R.2d 94-6344 (M.D. Tenn. 8/25/04), *aff'd*, 432 F.3d 678 (12/29/05). Tax shelter promoter was permanently enjoined under § 7408 from selling the so-called "Tax Toolbox" which would permit the deduction of personal expenses by falsely characterizing them as business expenses.

a. Anderson v. IRS, 442 F. Supp. 2d 365 (E.D. Tex. 5/18/06). Penalties under § 6700 were imposed on a customer-promoter, who sold 81 "Tax Toolbox" tax reduction schemes.

2. Mortensen v. Commissioner, 2006-1 U.S.T.C. ¶50,194 (6th Cir. 2/28/06). The court (Judge Martin) affirmed the imposition of the § 6662(a) negligence penalty imposed for the 1991 year on an investor in "The 1,000 lb. Tax Shelter," which was one of the Hoyt cattle-breeding partnerships. The court found that taxpayer, who was college educated with a degree in engineering, could not reasonably rely on his father's telling him that he [the father] showed the information about the investment to [an unnamed] tax attorney and that the "attorney looked over it and he said there was nothing illegal," The court further held he could not rely on information provided by Hoyt and Hoyt's "enrolled agent" status because Hoyt had a conflict of interest, and he could not rely on a co-worker's trip to the Hoyt ranch where he saw cows and an operating business.

• Taxpayer did not show "reasonable cause" under § 6664(c)(1) with respect to penalties on disallowed cattle tax shelter deductions resulting from the "Hoyt 1000 lb. Tax Shelter" where (1) taxpayer claimed reliance on the advice of tax shelter promoter, who happened to be an enrolled agent, (2) taxpayer never sought any advice from a disinterested tax professional with whom he dealt directly regarding the partnership investment generally or correctness of the his Schedule K-1 from the partnership, despite continuing large losses resulting from a small investment and receipt of continuous warnings from the IRS that the deductions were improper, and (3) taxpayer claimed reliance on the Tax Court's opinion in *Bales v. Commissioner*, T.C. Memo. 89-568, which upheld deductions claimed by other taxpayers in different years in a different cattle tax shelter partnership organized by the same promoter.

• The court further held that Mortensen's reliance on *Bales v. Commissioner*, T. C. Memo. 1989-568, was unwarranted because it involved "different investors, different partnerships, different taxable years, and different issues," although the court held that while "we believe it to be a closer case on this issue, we cannot conclude that the Tax Court clearly erred."

• The court stated, "The issue is not whether a taxpayer is wholly successful in determining the tax legitimacy of a desired investment, but whether he is negligent for not reasonably investigating in the first place," and "a reasonable taxpayer after *Bales* would still have sought independent counsel."

a. Van Scotten v. Commissioner, 439 F.3d 1243 (10th Cir. 3/9/06). The Tenth Circuit made a substantially similar analysis on substantially similar facts denying the § 6664(c)(1) "reasonable cause" exception to accuracy related penalties for another investor in the "Hoyt 1000 lb. Tax Shelter."

3. **Tax-exempt organizations will be subject to tax shelter penalties.** **TIPRA** § 516(a) adds new § 4965 to impose an excise tax on tax-exempt entities entering into prohibited tax shelter transactions. The tax will be 35 percent of the greater of (a) the entity's net income or (b) 75 percent of the proceeds received by the entity that are attributable to the transaction.

a. **TIPRA** § 516(b) also amends § 6033(a) to provide disclosure requirements and amends § 6652(c) to provide penalties for nondisclosure.

b. **TIPRA** § 516(b) also adds new Code § 6011(g), which requires a taxable party to a prohibited tax shelter transaction to provide a disclosure statement to any tax-exempt entity which is also a party to the transaction, indicating that the transaction is a prohibited tax shelter transaction. A failure to make a disclosure required under § 6011(g) is subject to penalty under § 6707A, with the penalty amounts the same as for other violations of § 6011 penalized by § 6707A.

E. Tax Shelters Miscellaneous

1. **"Too good to be true?"** Notice 2006-31, 2006-15 I.R.B. 751 (3/16/06). This notice reminds taxpayers not to engage in abusive tax-avoidance schemes that purportedly allow them to reduce or eliminate taxes based on "false or frivolous arguments." The notice states that "If an idea to save on taxes seems too good to be true, it probably is."

a. The rulings concurrently released and published are: Rev. Rul. 2006-17 (inserting the phrase "*nunc pro tunc*" on a return or other document has no legal effect); Rev. Rul. 2006-18 (submitting zero-income returns through a misinterpretation of § 3401(c) to the effect that "wages" are paid only to federal employees and persons living in Washington, DC); Rev. Rul. 2006-19 (attributing income to a purported trusts and claiming expense deductions for "fiduciary fees" in the amount of that income); Rev. Rul. 2006-20 (claims that American Indians are exempt from taxes under a general "Native American Treaty"); and Rev. Rul. 2006-21 (claiming there is no requirement to file an income tax return because the instructions do not display a current control number assigned by OMB under the Paperwork Reduction Act of 1980, Pub. L. No. 96-511 [codified at 44 U.S.C. § 3501).

- **While the above rulings involve tax protester-type schemes, the phrase "too good to be true" is not the be-all and end-all of tax planning.** *See*, N. Jerold Cohen, "Too Good To Be True and Too Bad To Be True," 109 Tax Notes 1437 (Dec. 12, 2005), described as follows: "In this report, the author questions whether it is fair to impose penalties on taxpayers on the grounds that their tax results were 'too good to be true' when the literal language of our code often produces results that many would think were either too good or too bad to be true."

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **If intermediate sanctions apply, is revocation far behind?** REG-111257-05, Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or If an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s), 70 F.R. 53599 (9/9/05). Provisions that clarify the relationship between the substantive requirements for tax exemption under § 501(c)(3) and the imposition of § 4958 excise taxes, i.e., intermediate sanctions – particular with respect to excess benefit transactions. Proposed Regulation §§ 1.501(c)(3)-1(g)(2)(ii) and (iii) read:

(ii) *Determining whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958-2 of this chapter) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and § 53.4958-4 of this chapter) that violate the prohibition on inurement under this section, the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following—(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred; (B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes; (C) Whether the organization has been involved in repeated excess benefit transactions; (D) Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and (E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958-7 of this chapter), or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (g)(2)(ii)(D) and (E) of this section will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (g)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

2. **IRS rules that seller-funded down-payment assistance programs do not qualify for exemption because the donors benefit from the transactions.** Rev. Rul 2006-27, 2006-21 I.R.B. (5/4/06). Three scenarios, the first and third [which conduct broad-based fundraising programs] qualify for exemption, but the second [which relies on a payment from the home seller] does not.

3. **According to the Fifth Circuit, it was the IRS that should have stayed home when it tried to show there was value in a group of home healthcare agencies that lost money on every transaction but made a profit on the volume.** Caracci v. Commissioner, 456 F.3d 444 (5th Cir. 7/11/06) (per curiam), *rev'g* 118 T.C. 379 (2002). The Fifth Circuit reversed the Tax Court and held that § 4958 excise taxes on excess benefits [intermediate sanctions] of more than $250 million were improperly proposed against the Sta-Home agencies, a group of family-owned and operated home health care agencies, on their conversion from tax-exempt corporations to nonexempt corporations. The decision was based on the significant errors in the analysis of the government's valuation expert, who provided the only support for the imposition of excise taxes. The Fifth Circuit concluded that, based on the record, the taxpayers did not receive any "net excess benefit" as a matter of law.

- The court faulted the government for issuing deficiency notices based on a brief intermediate internal analysis because the taxpayers refused to consent to an extension of the statute of limitations.

4. **Pension Protection Act** § 1212 amends Code §§ 4941-4945 to double the excise taxes on self-dealing and excess benefit transactions.

5. **IRS announces its credit counseling compliance project for tax-exempt credit counseling organizations.** Chief Counsel Advice CCA 200620001 (5/9/06). Contains two examples of credit counseling organizations: (1) ABC, which uses an educational methodology, and qualifies for exempt status under § 501(c)(3), and (2) DEF, which primarily promotes debt management plans without considering whether it is appropriate in light of each client's individual circumstances, and does not qualify for exempt status.

- The IRS also provided a Core Analysis Tool to help determine whether the credit counseling organization qualifies for exemption. 2006 TNT 94-12 (5/15/06).

a. IR-2006-80 (5/15/06). IRS releases a report on tax-exempt credit counseling agencies. The executive summary may be found at 2006 TNT 94-10.

b. **The IRS receives an assist from Congress in weeding out the "bad" credit counseling organizations. Pension Protection Act** § 1220 adds new Code § 501(q) to provide more definite rules governing tax-exempt credit counseling organizations, including, e.g., a limitation on the amount of the organization's income from debt management plan services.

6. **All tax-exempt organizations will be required to file annual electronic notices. Pension Protection Act** § 1223 adds new Code § 6033(i) to require electronic filing of an annual informational notice by all exempt organizations not currently required to file [specifically, organizations with gross receipts under $25,000 and churches] on pain of losing tax-exempt status. Effective for years beginning in 2007.

7. **Pension Protection Act** § 1225 amend Code § 6014 to require public disclosure of unrelated business income tax returns of § 501(c)(3) organizations. Effective for returns filed after date of enactment.

8. **Pension Protection Act** §§ 1231-1235 provide for new rules and greater accountability for donor advised funds and sponsoring organizations [e.g., community foundations], which are defined in these provisions. They also provide new requirements for supporting organizations, which are excluded from private foundation status under Code § 509(a)(3).

B. Charitable Giving

1. **Does new § 170(f)(12) close the door to inflated deductions for motor vehicle contributions?** Or, is the door left open wide enough to drive a truck [or other vehicle] through it? Section 884 of the **Jobs Act of 2004** amends § 170(f) by adding new paragraph 12 that requires written acknowledgment of contributions of motor vehicles, boats and airplanes that include the amount of the gross proceeds from any arm's length sale and a statement that the deduction may not exceed such amount. Its enactment was prompted by congressional concern that taxpayers who were donating used cars to charities were claiming deductions that far exceeded the amounts that the charities were receiving following the sale, often at auction, of the cars. Section 170(f)(12) applies if the claimed deduction is more than $500 and provides different rules depending on what the donee charity does with the vehicle. If the donee uses the vehicle or materially improves it, the taxpayer must obtain from the donee, and include with the tax return, a contemporaneous written acknowledgment that provides certain identifying information and certifies the intended use or material improvement of the vehicle, states the

intended duration of the use, and certifies that the vehicle will not be transferred or exchanged for money before the termination of such use or improvement. In this case the amount of the deduction is not affected. However, if the donee sells the vehicle without any significant intervening use or material improvement, the deduction cannot be more than the gross proceeds received from the sale, and other substantiation requirements apply. In addition to the other requirements, the donee's contemporaneous written acknowledgment must certify that the vehicle was sold in an arms-length transaction to unrelated parties, state the gross proceeds from the sale, and inform the donor taxpayer that the deductible amount may not exceed the gross proceeds.

- Donees that fail to furnish the required acknowledgment or furnish a false or fraudulent acknowledgment are subject to a penalty under § 6720, which was also added in 2004. For vehicles sold without intervening use or improvement the penalty is at least the gross proceeds from the sale but could be as much as the sales price on the acknowledgment multiplied by the highest marginal rate under §1 if that is higher. For other vehicles the penalty is the greater of $5,000 or the claimed value of the vehicle multiplied by the highest marginal rate under § 1.

a. **How much use is "substantial" when a charity uses a donated vehicle in its own endeavors?** Notice 2005-44, 2005-25 I.R.B. 1287 (6/20/05). The Notice provides interim guidance under the new rules for motor vehicle charitable contribution deductions. The most interesting examples are those where the charity puts the vehicle to use in delivering meals on wheels, where the question is whether the use is a "significant intervening use." Example 6 says use of the vehicle to deliver meals only a few times is not. Example 7 says that use of the vehicle to deliver meals every day for one year is. Example 8 says that driving the vehicle to deliver meals a total of 10,000 miles over a one-year period is.

b. **The IRS issues more guidance on reporting requirements for vehicle donations.** Notice 2006-1 (1/06/06).

- Background. Organizations must report donations on Form 1098-C, which will satisfy the requirements for donee acknowledgment letters as described in earlier guidance (Notice 2005-44, 2005-25 IRB 1287). The form must be revised, however, in light of the December 21, 2005, enactment of the Gulf Opportunity Zone Act, which requires that additional information be included in acknowledgment letters. Notice 2006-1 contains a transitional rule that relieves donee organizations from the additional requirements under the new law until Form 1098-C is revised. The notice also contains interim guidance for reporting the information contained in acknowledgment letters that were sent to donors in 2005 and guidance on the §6720 fraudulent acknowledgment penalty.

- Information reporting. If a donee organization receives a contribution of a qualified vehicle with a claimed value of more than $500.00 after December 31, 2004, the donee organization is required to provide a contemporaneous written acknowledgment to the donor. The donee organization may use a completed Form 1098-C for the contemporaneous written acknowledgment. See §3.03 of Notice 2005-44, 2005-25 I.R.B. 1287, for guidance on the information that must be included in a contemporaneous written acknowledgment and the deadline for furnishing the acknowledgment to the donor. Any donee organization that provides a contemporaneous written acknowledgment to a donor under this section is required to report to the Service the information contained in the acknowledgment. The report is due by February 28 (March 31 if filing electronically) of the year following the year in which the donee organization provides the acknowledgment to the donor. A donee organization that files Form 1098-C on paper should send it with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to the Internal Revenue Service Center, Ogden, UT 84201- 0027. A donee organization that is required to file 250 or more Forms 1098-C during the calendar year must file them electronically or magnetically. Specifications for Filing Forms 1098, 1099, 5498, and W-2G electronically or magnetically can be found in Publication 1220 at http://www.irs.gov/pub/irs-pdf/p1220.pdf. The filing of Form 1098-C does not relieve the donee organization of its obligation under §6050L to report information about dispositions of charitable deduction property on Form 8282, Donee Information Return. Please consult Notice 2006-1 for additional interim IRS guidance on written acknowledgments furnished to a donor in 2005.

2. Under the **Katrina Tax Act**, "qualified disaster contributions" made between 8/28/05 and 12/31/05 will be deductible without regard to the 50-percent-of-AGI limit.

3. Under the **Katrina Tax Act**, charitable deductions for contributions of food inventory would be permitted up to the lesser of (i) fair market value or (ii) twice basis; the same permitted deduction would apply to contribution of book inventory to public schools. Effective for contributions made between 8/28/05 and 12/31/05.

4. Sklar v.Commissioner, 125 T.C. 281 (12/21/05), *as amended*, 2/7/06. Another context in which taxpayers have repeatedly unsuccessfully sought to claim charitable contribution deductions for payments with respect to which they have received a *quid pro quo* is tuition payments to religious schools that provide both secular and religious education. Even if tuition can be mathematically prorated between the portion attributable to the secular education and the portion attributable to religious education, or the taxpayer can demonstrate that the tuition exceeds the value of the secular education, the deduction has been disallowed because taxpayers have unable to demonstrate any charitable intent in paying the tuition. The special exception for religious benefits does not apply to payments to religious schools

5. **No full fair market value deduction for contributed self-created musical compositions and copyrights. TIPRA** § 204 amends § 170(e)(1)(A) to provide that capital asset treatment, i.e., full fair market value deduction, is to be inapplicable to contributed self-created musical compositions and copyrights. The amount of the charitable deduction for the contribution of such assets is still to be reduced by the amount of appreciation inherent in non-LTCG assets, and, therefore, contributions of such assets will give rise to a deduction equal only to basis.

6. **Not asking is not the same as asking, getting and giving up.** Turner v. Commissioner, 126 T.C. No. 16 (5/16/06). Real estate developer, who purchased property which could be subdivided into 30 residential lots under current zoning, cannot get a contribution deduction for a § 170(h)(1) qualified conservation easement by forgoing an application for denser zoning usage under which he claimed to be entitled to develop up to 62 residences on smaller lots. However, one-half of the parcel was wetlands that could not have been developed, and only 30 houses could have built on the parcel in any event. Therefore, the conveyance did not "preserve" any open space that otherwise could have been developed. The 20-percent accuracy-related penalty was also upheld.

7. The **Pension Protection Act** makes the following changes to rules governing charitable contributions:

a. **Pension Protection Act** § 1213 amends Code § 170(h)(4) to provide that a donated façade easement must include an enforceable restriction which preserves the entire exterior of the building, and prohibits any change inconsistent with the historical character of the exterior.

b. **Bwana can deduct only the cost of taxidermy when he donates his big game trophies to a museum. Pension Protection Act** § 1214 adds new Code § 170(f)(15) to provide a limitation on deductibility of trophy mounts to the lesser of the fair market value of the trophy or the cost of taxidermy, effective for contributions after 7/26/06.

c. **Pension Protection Act** § 1215 adds new Code § 170(e)(7) to provide for recapture of the deduction in excess of the basis of exempt use tangible personal property if the property is disposed of within three years of the date of the donation. A civil penalty of $10,000 is provided under § 6720B for fraudulent identification of exempt use property.

d. **President Clinton could no longer deduct the underwear he contributes to charity, but Monica might still deduct her blue dress with white polka dots. Pension Protection Act** § 1216 adds new Code § 170(f)(16) to deny deductions for clothing and household items unless such clothing or household item is in "good used condition or better." Treasury may issue regulations denying a deduction for a contribution of clothing or household items of minimal monetary value. There is an exception for a contribution of a single item of clothing or a household item for which a deduction of more than $500 is claimed if the taxpayer attaches to his tax return a qualified appraisal with respect to the property.

e. **Those $20 bills placed in the collection plate each week will no longer be deductible without a receipt. Pension Protection Act** § 1217 adds new Code § 170(f)(17) to deny deductions for monetary gifts unless the donor has a bank record or a receipt showing the name of the donee organization, the date of the contribution and the amount of the contribution. Effective in 2007.

f. **Fractional interests in tangible personal property must carry with them substantial use by the donee in its exempt function. Pension Protection Act** § 1218 adds new Code § 170(o) to provide for recapture of any deduction (plus interest) allowed with respect to any fractional interest in tangible personal property unless the donor conveys all of the remaining interest in the property to the charity within the earlier of ten years or the donor's death. Additionally, recapture will take place unless within that period the donee has had substantial physical possession of the property and used the property in a use related to a purpose or function constituting the basis for the organization's exemption.

X. TAX PROCEDURE

A. Interest, Penalties and Prosecutions

1. **But will he be a "survivor" in the U.S. Court for the District of Rhode Island?** www.usdoj.gov/opa/pr/2005/September/05_tax_463.htm published a Justice Department news release, dated 9/8/05, announcing that Richard Hatch was indicted on charges of tax evasion for failing to report about $1,037,000 dollars of income from the television reality series and about $391,000 of income from other sources. He was convicted on 1/25/06, 2006 TNT 17-6.

2. **When is disclosure adequate? There are different rules for disclosure of a tax shelter, of transactions that lack reasonable basis and supporting records, and for preparer penalty purposes.** Rev. Proc. 2005-75, 2005-50 I.R.B. 1137 (12/12/05). Updates guidance on whether disclosure of a position taken on a tax return is adequate for purposes of the § 3332(d) accuracy-related penalty and the § 6694(a) preparer penalty.

- There is a new paragraph in § 4.01(5) cautioning that the entry of an amount on a line will not provide adequate disclosure if it is attributable to a tax shelter or "if it does not have a reasonable basis and supporting records," as well a limitation on its effectiveness for preparer penalty purposes.
- There is also a requirement in § 4.02(1)(d) that the contemporaneous written acknowledgment required under § 170(f)(12) for charitable contributions of motor vehicles be attached to the return.

3. Lewis v. United States, 96 A.F.T.R.2d 2005-6307 (W.D. Tenn. 9/12/05) CEO/president who was aware of financial strains on corporation, was informed by concerned subordinates on more than one occasion that the payroll taxes were not being paid, and whose "apparent choice to turn a blind eye and a deaf ear to these warnings," while shifting the blame to the CFO was liable for § 6672 penalty. Note that both CEO and CFO were responsible persons.

4. United States v. Hempfling, 2006-1 U.S.T.C. ¶50,205, 96 A.F.T.R.2d 2005-6578 (E.D. Cal. 9/23/05). In as lawsuit seeking an injunction under §§ 6700 and 7408 against a promoter of scheme: (1) purporting to demonstrate that there is no law requiring individuals to file federal income tax returns or pay income taxes, and (2) insulating purchasers who stopped filing tax returns from any charge of willful failure to file a tax return the court denied the promoter's motion to dismiss, holding that the First Amendment does not protect such "false or fraudulent commercial speech."

a. United States v. Hempfling, 431 F. Supp. 2d 1069 (E.D. Calif. 2/22/06). The court again refused to dismiss on defendant's contention that he had new evidence that the Sixteenth Amendment was never properly ratified. The court further held that the issuance of an injunction against the promotion of abusive tax shelters does not violate the *Noerr-Pennington* doctrine (see *Eastern R. Conf. v. Noerr Motors*, 365 U.S. 127 (1961); *Mine Workers v. Pennington*, 381 U.S. 657 (1965)), which protects the right to petition the government for redress of grievances.

5. Temp. Reg. § 1.6664-2T(c) provides that the amount reported on a "qualified amended return" will be treated as an amount shown as tax on the taxpayer's return for purposes of determining whether there is an underpayment of tax subject to an accuracy-related penalty. Generally speaking, an amended return is a "qualified amended return" if it is filed before the IRS first contacts the taxpayer concerning an examination of the return. Temp. Reg. §1.6664- 2T(c)(3).

6. **Sentence of 360 months for torching the Colorado Springs IRS office was upheld.** United States v. Dowell, 430 F.3d 1100 (10th Cir. 12/6/05). The court upheld a conviction under § 7212(a) and 18 U.S.C. § 2 for forcibly interfering with IRS employees and administration by setting fire to an IRS office.

7. United States v. Petrino, 2006 TNT 87-7 (E.D. N.Y. 5/2/06). Robert Fink won a jury acquittal for Paul D. Petrino, an accountant charged with tax evasion for filing returns based on the argument that wages and salaries are not subject to federal income tax. Fink said, "The jury was convinced that the government did not negate [Petrino's] good faith."

8. McGowan v. Commissioner, 98 AFTR 2d 2006-5023 (11th Cir. 6/28/06). Taxpayer's conviction under § 7206(1) of willfully making and subscribing false individual income tax returns and under § 7206(2) of willfully aiding and assisting in the preparation of false corporate income tax returns for the his S corporation did not collaterally estop him from

arguing successfully to a jury that his individual returns were not fraudulent because intent to evade taxes is not an element of crimes under § 7206.

9. **Government lawyers should "work with vigor" because the Seventh Circuit does a time-and-motion study of the DOJ Tax Division.** Szopa v. United States, 460 F.3d 884 (7th Cir. 8/21/06). Judge Easterbrook held that the DOJ Tax Division is setting the presumptive sanction for a frivolous appeal in this tax protest case too high because it should not take 53 attorney hours plus 8 hours of paralegal time to prepare a 15-page brief in response to taxpayer's brief of 9 double-spaced typed pages based entirely on the argument that "non-corporate citizens of the United States need not pay 'income taxes.'" The court did note that the Tax Division is free to request more when "the case is especially complex or the tax protester's argument especially long and opaque."

B. Discovery: Summonses and FOIA

1. **Honi soit qui mal y pense.** United States v. BDO Seidman, LLP, 2005-1 U.S.T.C. ¶ 50,264 (N.D. Ill. 3/30/05). The district court ruled that only one of 267 documents withheld from IRS scrutiny by the intervenors were unprotected by privilege or work produce, or both.[2] In ruling that the crime-fraud exception did not apply, Judge Holderman found that neither the existence of cookie-cutter tax opinions nor the IRS listing of substantially similar transactions as abusive tax shelters by the IRS was determinative because "the tax code and underlying regulations is [sic] full of complexities and uncertainties." He further stated that "just because one of BDO's consulting agreements has been found to have [been] fraudulent does not mean that all consulting agreements entered into by BDO were fraudulent."

- Judge Holderman found the test for the § 7525(b) tax shelter exception to be the same as for the crime-fraud exception.

- Footnote 2 of the opinion sets forth the categories of information contained in the privilege log. Inasmuch as the adequacy of another privilege log in this litigation was questioned, the categories in this privilege log might be a useful guide.

a. **The attorney-client privilege does not attach to communications relating to planning to commit tax fraud.** Subsequently, at 2005-2 U.S.T.C. ¶ 50,447; 95 A.F.T.R.2d 2005-2835 (N.D. Ill. 5/17/05). Judge Holderman found the remaining document examined *in camera* presented a *prima facie* case for being not privileged by reason of the crime-fraud exception, and the intervenors failed to present sufficient explanation to rebut that presumption. The document involved an investment in distressed debt with the sole motive of obtaining a loss for tax purposes.

- The government had argued that "document A-40 is not part of legitimate year-end tax planning, but instead is part of the overall abusive sham tax shelter transaction perpetrated by BDO and invested in by Intervenor Cullio and others."

- Judge Holderman refused to quash the summons seeking production of document A-40, which he held related to an "abusive sham tax shelter investment," because the IRS made a prima facie case that the crime-fraud exception to the attorney-client privilege applied and taxpayer failed to provide a satisfactory explanation of why the document should not be disclosed under the crime-fraud exception; there were eight indicators of potential fraud: (1) the marketing of pre-packaged transactions by BDO; (2) the communication by the taxpayer to BDO with the purpose of engaging in a pre-arranged transaction developed by BDO or

[2] The unprotected document was an e-mail sent by a BDO employee.

a third party with the sole purpose of reducing taxable income; (3) BDO and/or the taxpayer attempting to conceal the true nature of the transaction; (4) actual or constructive knowledge by BDO that the taxpayers lacked a legitimate business purpose for entering into the transaction; (5) vaguely worded consulting agreements; (6) failure by BDO to provide services under the consulting agreement despite receipt of payment; (7) mention of a particular tax shelter that had been identified by the IRS as a "listed transaction": and (8) use of boiler-plate documents).

- Both of Judge Holderman's decisions are on appeal to the Seventh Circuit.

2. **The *Powell* requirement that the summonsed documents provide information not already in the IRS's possession is being more rigorously enforced.** United States v. Monumental Life Ins. Co., 440 F3d 729 (6th Cir. 3/3/06), *rev'g* 345 F. Supp. 2d 712 (W.D. Ky. 10/8/04). The Sixth Circuit reversed the district court and denied enforcement of an IRS summons because the IRS already in its possession many of the documents containing the information sought in the summonsed documents – even though it obtained the information after the summons was issued. The burden is on the government rather than on the taxpayer to demonstrate that the government's interests outweigh the taxpayer's hardship, and the government was offered the opportunity to craft a more narrowly-tailored summons.

C. Litigation Costs

1. Blasius v. Commissioner, T.C. Memo. 2005-214 (9/15/05). Advance notice of proposed rule making (ANPRM) and proposed regulations are not "applicable published guidance" raising the presumption that the government's position was not justified; nor is the IRS Chief Counsel's "priority guidance plan" to be considered "applicable published guidance."

2. Moulton v. United States, 429 F.3d 352 (1st Cir. 11/21/05). Denying attorney's fees in case in which § 6672 penalty was upheld for only one of five quarters; government's position was substantially justified because case was a "close case" and "[t]he closeness ... was compounded by the fact that, once the IRS assessed [penalties] under § 6672, the burden of proof was on [taxpayers] to prove that they were not responsible persons (or that, if they were responsible, their failure to ensure that the taxes were paid was not "'willful'").

3. Urban v. United States, 2006-1 U.S.T.C. ¶50,211, 97 AFTR2d 2006-751 (N.D. Ill. 1/24/06). Attorney's fees were awarded in a § 6672 case where (1) the government's "physical evidence was totally insufficient to prove its case," and (2) the government based its case on testimony of witnesses that was "inherently incredible ... biased, self-serving, perhaps acquired in a deal with the IRS and ... impeached at trial."

4. **The circuits are split on whether attorney's fees may be awarded to a pro se taxpayer, but the Second Circuit has not yet spoken. A bankruptcy court in New York answers "yes."** In re Hudson, 97 AFTR2d 2006-2693 (Bankr. N.D. N.Y. 5/16/06). A pro se taxpayer who prevails against government's position that was not substantially justified can recover an amount equal to reasonable attorney's fees.

D. Statutory Notice

1. **In cases where the IRS has determined that the taxpayer realized unreported income, the Commissioner must provide a minimal evidentiary foundation for the deficiency determination before the presumption of correctness attaches to it.** McManus v. Commissioner, T.C. Memo. 2006-057 (3/27/06). Without a minimal evidentiary foundation for the deficiency determination, Judge Haines held that the burden of going forward with the

evidence shifts from the taxpayer to the Commissioner – wholly apart from § 7491 – on the ground that the notice of deficiency is arbitrary.

E. Statute of Limitations

1. Bacigalupo v. United States, 399 F. Supp. 2d 835 (M.D. Tenn. 11/15/05). Twelve-month limitation period governing claims filed in probate proceedings pursuant to state law did not bar claim for unpaid income taxes filed by the IRS against the estate in the probate proceeding; citing *United States v. Summerlin*, 310 U.S. 414 (1940), and *United States v. John Hancock Mutual Life Ins. Co.*, 364 U.S. 301 (1960). The statutes of limitations provided in the Internal Revenue Code pre-empt any state law statutes of limitations. The United States is not bound by any state law statutes of limitations that might require a claim to be asserted within a period shorter than the period provided by the Internal Revenue Code.

2. Pacific Gas & Electric Co. v. United States, 417 F.3d 1375 (Fed. Cir. 8/10/05), *rev'g* 55 Fed. Cl. 271 (2003), *rehearing en banc denied* on 1/13/06. Erroneous overpayment of interest on overpayment of taxes could be setoff against subsequent refund claim. In addition, the government can setoff the erroneous refund against other refunds due to the taxpayer, but the IRS's cannot set off erroneously paid interest against a taxpayer's timely refund claim with respect to the same year, if the statute of limitations on bringing suit for the erroneous payment of interest has expired.

3. Benson v. Commissioner, T.C. Memo. 2006-55 (3/27/06). Items on the tax returns of brother-sister corporations reflecting payments between them, which on the facts were found to be constructive dividends to their common shareholder, did not constitute adequate disclosure with respect to the shareholder's return to prevent the § 6501(3)(1)(A) six-year statute from being applicable.

4. **The informal claim doctrine may not apply in a suit for refund.** Computervision Corp. v. United States, 445 F.3d 1355 (Fed. Cir. 4/20/06). An amendment of a refund claim filed after the statute of limitations had run and which claimed a different amount under a different theory was not germane to the original refund claim and thus did not relate back.

a. **Or, it may apply.** Parker Hannifin Corp. v. United States, 71 Fed. Cl. 231, 2006-1 U.S.T.C. ¶50,364, 97 AFTR2d 2006-2568 (Fed. Cl. 5/23/06). An amendment of a refund claim after the statute of limitations had run on an original timely-filed refund claim seeking approximately $89,000 of allegedly overpaid interest on a deficiency, to increase the claim to approximately $9.1 million, was germane to the original refund claim because it was based on the same theory, and thus related back.

F. Liens and Collections

1. REG-150088-02, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Prior to Levy, 70 F.R. 54687 (9/16/05); REG-150091-02, Miscellaneous Changes to Collection Due Process Procedures Relating to Notice and Opportunity for Hearing Upon Filing of Notice of Federal Tax Lien, 70 F.R. 54681 (9/16/05).

- Prop. Reg. § 301.6320-1(c)(2), Q&A-C1. Written request must state the taxpayer's reason for disagreeing with the lien filing. Taxpayers are encouraged to use Form 12153, Request for a Collection Due Process Hearing. A taxpayer must request a hearing in writing.

• Reg. § 301.6320-1(d)(1), Q&A-D6; see also Prop. Reg. § 301.6320-1(d)(2), Q&A-D8. Face-to-face conference concerning a taxpayer's underlying liability will not be granted if the request or other communication indicates that the taxpayer will only raise irrelevant or frivolous issues. A face-to-face conference concerning a collection alternative, such as an installment agreement or an offer to compromise liability, will not be granted if the alternative would not be available to other taxpayers in similar circumstances, for example, a face-to-face conference will not be offered to a taxpayer who wishes to make an offer to compromise but has not filed a return. A face-to-face conference need not be granted if the taxpayer does not provide the required information. If, however, the taxpayer fails to provide the IRS with information that he will raise substantive arguments raises that are not frivolous or tax-protester type arguments, the IRS may deny the taxpayer a face-to-face hearing and provide the hearing by correspondence or telephone.

• Prop. Reg. § 301.6320-1(d)(2), Q&A-D7. The proposed Regulations would clarify that a face-to-face meeting is merely one aspect of a collection due process hearing, and that a review of documentation and notes of oral conversations with the taxpayer can supplement, or constitute in and of themselves, the "hearing."

• Prop. Reg. § 301.6330-1(f)(2), Q&A-F7. The proposed regulations would expressly limit judicial review to issues (including a challenge to the underlying tax liability) that were properly raised in the taxpayer's collection due process hearing.

2. Clark v. Commissioner, 125 T.C. 108 (9/26/05). Taxpayer filed timely petition in Tax Court following receipt of notice of intent to levy. Furthermore, the Tax Court has held that § 6330(d) confers on it the jurisdiction to review an IRS determination to levy on the taxpayer's state income tax refund, even though § 6330(f) permits the IRS to so levy without first affording the taxpayer a pre-levy hearing.

3. Springer v. United States, 96 AFTR2d 2005-6846 (W.D. Okla. 10/6/05). The district court lacks jurisdiction to enjoin a levy for income tax liability because jurisdiction to review IRS's determination in CDP hearing regarding income taxes lies to the Tax Court. In addition, § 6330(e)(1) authorizes the court to which jurisdiction to seek review of the IRS's determination in a collection due process hearing under §§ 6320 and 6330 lies to enjoin any attempt by the IRS to levy on the taxpayer's property during the period for which the administrative collection due process hearing and judicial review thereof are pending.

4. Drake v. Commissioner, 125 T.C. 201 (10/12/05). IRS abused discretion by virtue or an *ex parte* communication from IRS agent to Appeals Officer assigned to conduct the collection due process hearing, because the communication revealed the IRS originating function's perception of the taxpayer's credibility in contravention of the requirements of Rev. Proc. 2000-43, 2002-2 CB 404; case remanded for a new collection due process hearing.

5. Magee v. Commissioner, T.C. Memo. 2005-263 (11/16/05). Levy based on tax liability reported on a joint return but which was not paid may be contested in a collection due process hearing, but claim that the taxpayer's signature on the joint return was forged does not necessarily place the underlying liability in issue.

6. Aranda v. Commissioner, 96 AFTR2d 2005-7461 (10th Cir. 12/20/05). The IRS did not abuse its discretion in granting relief from the fraud penalty and interest on the fraud penalty, but not from any portion of the underlying tax deficiency liability, pursuant to § 6015(f), even though taxpayer requested relief under § 6015(b), not § 6015(f) and the IRS notice mistakenly referred to relief being granted under § 6015(b).

7. Greene-Thapedi v. Commissioner, 126 T.C. No. 1 (1/12/06). Tax Court is divested of jurisdiction where IRS applies overpayment from another year to satisfy deficiency after issuing determination in CDP hearing, even though taxpayer is contesting existence of the liability on the asserted grounds that she had not received a deficiency notice; because there was neither an unpaid liability nor a levy, there was no action subject to review; taxpayer had "no independent basis to challenge" the underlying tax liability in the Tax Court because it could not exercise jurisdiction over a refund claim.

8. **Tax Court makes it easier to find abuse of discretion in collection due process hearings.** Robinette v. Commissioner, 123 T.C. 85 (7/20/04) (reviewed, 14-3). In 1995, the taxpayer had entered into an offer in compromise (based on doubts as to collectibility) relating to years prior to 1992, which required that he file timely returns for 1995 through 1999. The returns for 1995 through 1997 were timely filed, but the 1998 return was never received. The taxpayer and his accountant claimed that on the day the 1998 return was due, his accountant prepared it, the taxpayer signed it, and the accountant mailed it using a private postage meter [Uh-oh]. The IRS declared the compromise in default. After a due process hearing in which the taxpayer claimed good faith compliance and offered alternative proof of mailing, including a copy of the 1998 return, the Appeals Officer issued a notice of determination to proceed with collection, because the Appeals Officer would accept only a certified or registered mail receipt as proof of mailing. Even though the Tax Court's review of collection due process hearings is for abuse of discretion, in a reviewed opinion by Judge Vasquez (in which 5 judges joined), the Tax Court held that it may consider evidence presented at trial that was not in the administrative record (but not new issues). The court held that the Administrative Procedures Act review provisions do not apply to § 6330(d) proceedings, and admitted taxpayer's testimony that he signed and delivered returns to his accountant for mailing, the accountant's testimony regarding the procedures used to mail the return, and other evidence not in the administrative record indicating that the return was mailed. Although the testimony was admitted, it did not prove timely mailing because the accountant used a private meter and the return was not received until several years later when the copy was delivered to Appeals. Nevertheless, the court held that the taxpayer did not materially breach the offer in compromise and that the Appeals Officer abused his discretion in declaring the compromise in default. There were an indescribable number of overlapping concurrences by an additional nine judges, in some of which the five "majority" judges joined, and one of which concurring opinions was supported by more judges than supported the "majority" opinion; there were three dissents.

a. **Chief Counsel's response.** Chief Counsel Notice CC-2004-031 (9/1/04). Deborah Butler provides guidance to Chief Counsel attorneys as to how to handle Collection Due Process cases in light of *Robinette*. The recommended course of action when such evidence is presented to the court is to ask for a remand of the case to Appeals for a supplemental determination.

b. Murphy v. Commissioner, 125 T.C. No. 15 (12/29/05), *government petition for rehearing en banc*, 10/5/06. The Tax Court (Judge Halpern) declined to overrule *Robinette*, but excluded taxpayer's proffered testimony as to the nature of his illness which allegedly precluded him from making a larger offer in compromise because taxpayer had "more than an adequate opportunity to provide [the Appeals Officer] with all of the evidence" and declined to do so. The court went on to state: "An appeals officer does not abuse her discretion when she fails to take into account information that she requested and that was not provided in a reasonable time."

c. **Reversed because the case should have been reviewed based upon the evidence presented to the Appeals Officer.** Robinette v. Commissioner, 439 F.3d 455 (8th Cir. 3/8/06). Inasmuch as the Tax Court reviews the decision of an appeals officer under an "abuse of discretion" standard of review, the record on review under both the Administrative Procedure Act and general principles of administrative law is "ordinarily limited to consideration of the decision of the agency ... and of the evidence on which it was based."

- Judge Colloton did not think that because the Tax Court traditionally conducts *de novo* proceedings in deficiency cases, Congress meant it to conduct such proceedings in collection due process cases.

9. Manko. v. Commissioner, 126 T.C. No. 9 (4/20/06). On taxpayer's challenge to enforcement of a levy, Judge Kroupa held that where a taxpayer has executed a closing agreement on Form 906, which only finally determines one or more separate items affecting the taxpayer's liability, the IRS must nevertheless issue a statutory notice of deficiency before proceeding to collect any deficiency.

10. Zapara v. Commissioner, 126 T.C. No. 11 (4/25/06). Where the IRS failed to comply with taxpayer's request to sell seized stock within 60 days, the Tax Court (Judge Thornton) granted equitable relief by granting taxpayer a credit for the value of the seized stock as of the date by which it should have been sold under the statute; because the IRS's failure to adhere to follow the statutory mandate in § 6335(f) frustrated taxpayer's ability to use the stock to satisfy tax liabilities and increased taxpayer's risk with respect to the stock Therefore, the IRS must assume the risk of loss with respect to the stock.

11. Cox. v. Commissioner, 126 T.C. No. 13 (5/3/06). An Appeals officer is not disqualified from conducting a collection due process hearing for a later year by virtue of conduct of a prior collection due process hearing for the same taxpayer with respect to an earlier year, which is not "prior involvement" within the meaning of § 6330(b)(3), where the record does not otherwise call into question his impartiality.

12. Gorospe v. Commissioner, 446 F.3d 1014 (9th Cir. 5/3/06). On appeal, the court affirms the Tax Court's determination that it did not have jurisdiction over an appeal from collection due process proceedings with respect to trust fund recovery penalties under § 6630(d)(1)(B) because the Tax Court did not have jurisdiction over the underlying liability.

13. **Partial payment to be required on the submission of an offer-in-compromise. TIPRA** § 509 adds new § 7122(c) to require partial payments of 20 percent of lump-sum offers-in-compromise [oddly defined to include all offers featuring five or fewer installments], or the first installment of periodic payment offers-in-compromise, with the submission of such offers. Offers submitted without the required payments (unless a waiver is provided for under regulations to be issued) are to be returned to the taxpayer as unprocessable.

- **TIPRA** also added Code § 7122(f), which provides that an offer-in-compromise is deemed to have been accepted by the IRS if the IRS has not rejected it within two years of the date on which it was submitted.

a. Notice 2006-68, 2006-31 I.R.B. 105 (6/11/06). This notice contains interim guidance pending final regulations. Payments accompanying lump sum offers will be treated as a payment of tax, and not as a refundable deposit. If the taxpayer submits a periodic payment offer, it must be accompanied by the first installment and subsequent installments must be timely paid during the period of evaluation of the offer-in-compromise by the IRS, and will be similarly treated as payments of tax. Any applicable user fee must be paid along with the partial payment, but the user fee will serve to reduce the taxpayer's tax liability dollar-for-dollar. Voluntary payments in excess of the required payments will be treated as refundable deposits if they are not designated as tax payments by the taxpayer. No payment will be required when an offer is submitted by a low-income taxpayer or if an offer is submitted based solely on the basis of doubt as to liability.

14. **Pension Protection Act** § 855 amends code § 6330(d) to provide that all appeals of collection due process determinations are to be made to the Tax Court. Effective for determinations made more than 60 days after the date of enactment.

15. Bell v. Commissioner, 126 TC No. 18 (5/22/06). The Tax Court (Judge Foley) held that taxpayer was properly barred from raising fact of liability in § 6220 due process hearing because he had the opportunity to appeal to Tax Court from a determination letter issued after a previous § 6330 due process hearing and failed to do so.

16. Barnes v. Commissioner, T.C. Memo. 2006-150 (7/24/06). The Tax Court (Judge Laro) held that the IRS properly rejected taxpayers' offer in compromise based on promotion of effective tax administration because the taxpayers failed to identify compelling considerations of public policy or equity. A compromise based on promotion of effective tax administration is further not warranted because taxpayer's liability arose from a tax shelter scheme in which the they were allegedly defrauded by the promoter, because "[a] compromise on that basis would place the Government in the unenviable role of an insurer against poor business decisions by taxpayers." The IRS properly rejected the offer in compromise based on the alternative ground of doubt as to collectibility because the taxpayers offered less than they were able to pay and the IRS's rejection of offer was "a reasonable application of the guidelines, which we decline to second guess," and was not abusive or unfair. Judge Laro noted that under Reg. § 301.7122-1(c)(3), "economic hardship" exists where a taxpayer is "unable to pay his or her reasonable basic living expenses," and the taxpayers must articulate with specificity the purported economic hardship they will suffer if they are not allowed to compromise their liability).

- Judge Laro refused to consider additional evidence offered by taxpayers that was not offered during the administrative proceeding, stating, "as we read petitioners' memorandum in the light of the record as a whole, petitioners wanted to include the external evidence in the record of this case to prove that [the Appeals officer] abused her discretion by not considering facts and documents that they had consciously decided not to give to her."

17. Cristopher Cross, Inc. v. United States, 461 F.3d 610 (5th Cir. 8/21/06). Appeals officer did not abuse her discretion in returning an offer in compromise as "nonprocessable" based upon the Internal Revenue Manual. Taxpayer had offered $85,000 on a deferred payment schedule to settle an assessed liability for employment taxes of $134,078 for four quarters. The offer was rejected for the reasons that (1) the taxpayer had not timely made federal tax deposits of estimated tax, and (2) it had more than sufficient equity in accounts receivable and moveable assets to pay the tax in full.

G. Innocent Spouse

1. **No "plain language" limitation of the Tax Court's jurisdiction in this case.** Ewing v. Commissioner, 118 T.C. 494 (5/31/02). The taxpayer and her husband filed a joint return but did not pay all of the tax shown on the return. Subsequently, before the IRS

asserted any deficiency, the taxpayer requested equitable relief from joint and several liability under § 6015(f). The IRS denied relief and mailed a notice of determination that was not mailed to the taxpayer's last known address, but was actually received by the 88th day after it was mailed. The taxpayer's petition for review was postmarked 92 days after the mailing of the notice, and was received and filed seven days later. The Commissioner moved to dismiss on the ground that the petition was not timely filed. The Tax Court *sua sponte* raised the issue of whether it had jurisdiction under § 6015(e) to review the IRS's denial of § 6015(f) relief where no deficiency had been asserted. [Section 6015(e), granting the Tax Court jurisdiction to review denials of § 6015 relief, as amended by the Consolidated Appropriations Act of 2001, begins, "In the case of an individual against whom a deficiency has been asserted and who elects to have subsection (b) or (c) apply..."] In a reviewed opinion by Judge Ruwe, the majority (9-4) held that the Tax Court has jurisdiction to review an denial of § 6015(f) relief in a stand alone petition where the taxpayer is seeking relief from liability of tax shown on the return, without a deficiency having been asserted. The court further held that the petition was timely because it was filed more than 6 months after the date she submitted her request for relief [see. § 6015(e)(1)(A)], the IRS failed to mail the notice of determination to taxpayer's last known address, and the misaddressed notice prejudiced the taxpayer's ability to file her petition within 90 days after the mailing of the notice. The court concluded that:

> [T]he language "against whom a deficiency has been asserted" was inserted into section 6015(e) to *** to prevent taxpayers from submitting premature requests to the Commissioner for relief from potential deficiencies before the Commissioner had asserted that additional taxes were owed. *** Congress was concerned with the proper timing of a request for relief for underreported tax and intended that taxpayers not be allowed to submit a request to the Commissioner regarding underreported tax until after the issue was raised by the IRS.
>
> There is nothing in the legislative history indicating that the amendment of section 6015(e) ***, was intended to eliminate our jurisdiction regarding claims for equitable relief under section 6015(f) over which we previously had jurisdiction. The stated purpose for inserting the language "against whom a deficiency has been asserted" into section 6015(e) was to clarify the proper time for a taxpayer to submit a request to the Commissioner for relief under section 6015 regarding underreported taxes. We conclude that the amendment of section 6015(e) does not preclude our jurisdiction to review the denial of equitable relief under section 6015(f) where a deficiency has not been asserted. In the instant case, petitioner filed a claim for relief from joint and several liability for an amount of tax correctly shown on the return but not paid with the return. Because respondent has not challenged the tax reported on the return, no deficiency has been asserted. In this situation, petitioner may be entitled to relief under section 6015(f) because subsection (f) applies where "it is inequitable to hold the individual liable for *any unpaid tax or* any deficiency." [citations omitted].

• Judge Laro's dissent argued that the Tax Court lacked jurisdiction to review the denial of § 6015 relief in the absence of a deficiency, because he considered § 6015(e)(1) to be a "clear statutory mandate from Congress" limiting the Tax Court's jurisdiction to review denials of § 6015 relief to deficiency cases.

a. Ewing v. Commissioner, 122 T.C. 32 (1/28/04). In a reviewed opinion by Judge Colvin, the Tax Court held that even though the standard for reviewing the Commissioner's failure to grant equitable relief under § 6015(f) is abuse of discretion, the Tax

Court's review is not necessarily limited to the facts that were in the administrative record. Judges Halpern, Holmes, Chiechi, and Foley dissented.

b. **Reversed, vacated and dismissed because the Tax Court did not have jurisdiction over taxpayer's petition in which she claimed innocent spouse relief.** Commissioner v. Ewing, 439 F.3d 1009 (9th Cir. 2/28/06). Judge Tashima held that the Tax Court did not have jurisdiction to review wife's petition for equitable relief under § 6015(f) because there was no deficiency asserted against her and she did not elect relief under § 6015(b) or (c), as is required by § 6015(e) in order for the Tax Court to have jurisdiction on an innocent spouse claim. The phrase in § 6015(e) "against whom a deficiency has been asserted" was added in 2001.

2. Estate of Capehart v. Commissioner, 125 T.C. No. 10 (11/14/05). Computation of the deficiency and penalty amounts allocable to the innocent spouse/wife based upon disallowed losses and medical expenses [erroneous items] is to be made under the proportionate allocation method after the disallowed items were allocated equally between the two spouses. The Tax Court (Judge Jacobs) held that § 6015(d) does not limit the portion of the deficiency properly allocable to the wife to her proportionate share of the taxable income properly reported on the joint return because her husband received a tax benefit from the filing of a joint return; this which limits the amount of the erroneous items that will be allocated to him (with the excess to be allocated to the wife).

- Although items are allocated for this purpose as if the spouses had filed separate returns, the allocation does not require that the innocent spouse's ultimate tax liability be limited to the amount that would have been her tax liability if separate returns actually had been filed. The deficiency is not allocated in proportion to taxable income, but rather the deficiency is allocated in proportion to the erroneous items giving rise to the deficiency that are assigned to each spouse. Reg. § 1.6015-3(d)(4)(i)(A).

3. Aranda v. Commissioner, 432 F.3d 1140, 2006-1 U.S.T.C. ¶50,136, 96 AFTR2d 2005-7461 (10th Cir. 12/20/05). IRS did not abuse discretion in granting relief from fraud penalty and interest on the fraud penalty, but not from any portion of the underlying tax deficiency liability, pursuant to § 6015(f), even though taxpayer requested relief under § 6015(b), not § 6015(f), and the IRS notice mistakenly referred to relief being granted under § 6015(b).

4. Ordlock v. Commissioner, 126 T.C. No. 4 (1/19/06) (reviewed, 10-8). Taxpayer is not entitled to a refund of amounts from community property used to pay her husband's tax liabilities understatements because under California state law community property is subject to an obligation of one spouse.

5. **Imagine the other stories he was ready to believe.** Motsko v. Commissioner, T.C. Memo. 2006-17 (2/2/06). The Tax Court (Judge Holmes) held that a taxpayer who signed a joint return prepared by his subsequently-imprisoned wife more than a year late, at a time when he knew that prior returns were under audit, had a "duty of inquiry" because a reasonable person in his position would have gotten suspicious that [his wife] was no longer behaving as expected." Inasmuch as the taxpayer made no inquiry, he did not qualify for the safe harbor in Rev. Proc. 2000-15, 2001-1 C.B. 448, § 4.02, and equitable relief was denied based on all the factors.

- Incidentally, taxpayer did not own the business he thought he owned; it was owned by a partnership between his wife and her brother.

6. Campbell v. Commissioner, T.C. Memo. 2006-24 (2/15/06). A wife who was financially unsophisticated had no knowledge of, and no duty to inquire as to, husband's sham losses purportedly incurred in commodities trading account – even though the trades were through an account in her name – because she was only a nominee, the sophisticated transactions "looked legitimate on paper," and "a reasonable person with [the wife's] educational background, devoid of any specific knowledge in options trading, could not be expected to discover that the trades were fictitious."

7. Rev. Rul. 2006-16, 2006-14 I.R.B. 694. A taxpayer is not precluded from seeking innocent spouse relief under § 6015 by virtue of the prior bankruptcy case filed by the taxpayer and the taxpayer's spouse in which the IRS filed a proof of claim, if the bankruptcy court did not make an actual determination of the liability. On the other hand, had the requesting spouse been debtor in the bankruptcy case, had meaningfully participated in the dischargeability proceeding, and had the bankruptcy court determined the tax liability on the merits, that determination generally would preclude the requesting spouse from subsequently receiving § 6015 relief.

H. Miscellaneous

1. **Proposed regulations reject the mailbox rule and hold that — absent actual delivery — only registered or certified mail will suffice as proof.** REG-138176-02, Timely Mailing Treated as Timely Filing, 69 F.R. 56377 (9/21/04). Proposed regulations under § 7502 to provide that a registered or certified mail receipt is the only prima facie evidence of delivery of documents that have a filing deadline prescribed by the internal revenue laws — other than direct proof of actual delivery.

a. **But taxpayers can still prevail based upon the mailbox rule. Why did taxpayers' lawyer play games with love by not taking the petition to the post office?** Grossman v. Commissioner, T.C. Memo. 2005-164 (7/5/05). The envelope sent by certified mail that contained taxpayer's petition to the Tax Court was timely postmarked by a private postage meter but was received by the court after the 90-day period for filing prescribed by § 6213(a). Taxpayer submitted evidence of a delay in delivery of this letter by reason of misdirection and irradiation to eliminate anthrax spores, as well as the testimony of their lawyer's office manager that she mailed the petition on the date it was postmarked by the private postage meter. The Tax Court (Judge Goeke) held that taxpayers met their burden of proof that their mailing was timely.

- For a tax return or other document mailed to the IRS, it is rumored that the IRS will accept the uncorroborated word of a practitioner believed to be credible as to the date of mailing.

2. **"It is an ill wind...."** Notice 2005-66, 2005-40 I.R.B. 620 (9/9/05). The IRS has postponed until 1/3/06 tax return filing and payment deadlines for taxpayers affected by Hurricane Katrina, i.e., taxpayers in three counties in Florida, six counties in Alabama, 52 counties in Mississippi and 64 parishes in Louisiana. the postponement was granted pursuant to § 7508A, which grants the IRS authority to postpone for a period of up to one year the time for performance of the acts listed in § 7508(a) by taxpayers affected by a Presidentially-declared disaster.

a. IR-2005-112 (9/28/05) and Notice 2005-73; 2005 IRB LEXIS 374; 2005-42 I.R.B. 723 (9/21/05). Pursuant to the **Katrina Tax Act**, the deadlines to file tax returns, pay taxes, and perform other time-sensitive acts is postponed until 2/28/06 for taxpayer affected by Hurricane Katrina. 2005 TNT 188-13.

3. **The four-month automatic extension will now be for six months.** T.D. 9229, Extension of Time for Filing Returns, 70 F.R. 67356 (11/7/05), and REG-144898-04, Extension of Time for Filing Returns, 70 F.R. 67397 (11/7/05). Final, temporary and proposed regulations (Temp. Reg. § 1.6081-4T; Prop. Reg. § 1.6081-4) that allow taxpayers required to file an individual income tax return an automatic six-month extension if taxpayers submit an application on Form 4868 ("Application for Automatic Extension of Time To File a U.S. Individual Income Tax Return") on or before the return due date.

- Temp. Reg. § 1.6081-5T also allows pass-through entities to file an automatic six-month extension of time to file on new Form 7004 ("Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information and Other Returns"). Effective for applications for an automatic extension of time filed after 12/31/05. Treasury requests comments as to whether pass-through entities should receive a shorter extension of time.

- Will this mean that return preparers will face a jam-up before October 15th because the former August 15th filers will wait until October to assemble their data?

4. **User fees for rulings increase.** IR-2005-144, 12/19/05. User fees for PLRs will increase from $7,000 to $10,000, with lower fees for taxpayers earning less than $250,000 ($625) and taxpayers earning from $250,000 to $1 million ($2,500). The fee for requests for changes in accounting methods for businesses will increase from $1,500 to $2,500. Other fees will also increase to be reflected in Rev. Procs. 2006-1 and 2006-8.

5. In Re: John Ashton Wray, Jr., 433 F.3d 376 (4th Cir. 12/29/05). This lawyer properly filed all his income tax returns but did not pay the all the taxes due, choosing instead to repay the lenders to his business. He pleaded guilty to a misdemeanor count of willful failure to pay income taxes. The opinion noted that it was not clear that the lawyer's conduct involved deceit, and that deceit was not a necessary element of IRC section 7203. There was no deceit, as the liability was disclosed. The attorney, if anything, was foolish for not simply requesting a payment arrangement. That's not to excuse the failure to pay, but on the spectrum of offenses, from failure to file and willful nondisclosure, this one isn't quite as bad as it sounds.

6. Service Employees International Union v. Commissioner, 125 T.C. 63 (9/15/05). Tax Court lacked jurisdiction to review IRS's determination to collect § 6652(c)(1) penalties for exempt organization's failure to file § 6033 annual return.

7. Mobil Corp. v. United States, 67 Fed.Cl. 708 (9/22/05). Claims on original tax return that were disallowed on audit, combined with the parties' course of dealing during the audit of those claims conducted prior to the expiration of the statute of limitations for filing an administrative refund claim, established all of the elements of a valid informal claim: (1) notice to Commissioner, (2) the factual and legal basis of the claim, and (3) a written component).

8. **It's good to know that all is normal on the home front despite our military serving in dangerous circumstances overseas. In this CCA, the IRS denies relief to a reservist serving in a combat zone by using an exact reading of the statute to arrive at the conclusion that a partnership whose principal partner is serving in a combat zone is not entitled to suspension of interest on delinquent payroll taxes.** CCA 200613030 (12/15/05). Legal memorandum determining that a partnership is not entitled to a § 7508 suspension of interest on delinquent payroll taxes while its "principal partner" is serving in a combat zone.

9. **There is a Form 1099 for tax exempt interest in your future. TIPRA** § 502 amends Code § 6049(b)(2) to eliminate the exception for tax-exempt interest from reporting requirements. Thus payors of tax-exempt interest will be required to report such interest on Form 1099. Applicable to interest paid after 12/31/05.

a. Notice 2006-93, 2006-44 IR.B.R. (10/4/06). Provides transitional relief for payors of tax-exempt interest during 2006 and the first quarter of 2007.

10. **Tax Court may apply the doctrine of equitable recoupment. Pension Protection Act** § 858 amends Code § 6214(b) to authorize the Tax Court to apply the doctrine of equitable recoupment.

11. **Duty of consistency prevents tax gamesmanship.** Janis v. Commissioner, 461 F.3d 1080 (9th Cir. 8/21/06). Taxpayer, as co-executor of his father's estate, agreed with the IRS on a discounted value [for blockage] of an extensive art collection held by his father [in a sole proprietorship, the Sidney Janis Art Gallery] included in the estate on the premise that flooding the market with the art works would depress the value of the art works. Later, in valuing the art gallery's inventory, taxpayer used the full undiscounted value of $36 million instead of the estate tax value of $14 million for purposes of calculating the gallery's income. Judge McKeown held that the duty of consistency should be applied in order to prevent inequitable shifting of positions by the taxpayer.

- The doctrine requires there be (1) a representation by the taxpayer [here, as beneficiary and co-executor of his father's estate], (2) reliance by the Commissioner, and (3) a change in position by the taxpayer after the statute of limitations has run. The court noted, "Such tax gamesmanship is exactly what the duty of consistency is designed to prevent."

12. **Houston SB/SE taxpayers may be guinea pigs for fast-track settlements.** Announcement 2006-61, 2006-36 I.R.B. (8/22/06). The IRS has extended the LMSB fast-track settlement program to SB/SE. The program will be available for a two-year test period, and for the first six months will be available only for taxpayers in Chicago, Houston, and St. Paul. Rev. Proc. 2003-40, 2003-1 C.B. 1044, implemented the program. Effective beginning 9/5/06.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. **TIPRA** § 511 adds new § 3402(t) to provide for a withholding tax of 3-percent on payments made to persons providing property or services to governmental entities.

B. Excise Taxes

1. **Telephone excise tax inapplicable to charges that do not vary by distance, says the Eleventh Circuit in its latest pronouncement on the "plain meaning" of the tax statutes.** American Bankers Insurance Group v. United States, 408 F.3d 1328 (11th Cir. 5/10/05). The long distance services provided by AT&T to taxpayer were not within the "toll telephone service" to which § 4252(b)(1) applies because the rates do not vary by "distance and elapsed transmission time" and the unambiguous statute uses these terms conjunctively; the "plain meaning" of the statute requires both the time and the distance to vary. Even though there are separate charges for calls depending upon where they fall within one of three toll bands used (intrastate, interstate and international), the rates do not vary by distance per se because calls between places closer to one another often cost more than calls between places further apart. The Eleventh Circuit reversed the district court's grant of summary judgment for the government.

a. **This one is the most fun to read because of the interplay between majority and dissenting opinions as to the meaning of "and."** OfficeMax Inc. v. United States, 428 F.3d 583, 2005-2 U.S.T.C. ¶70,246 (6th Cir. 11/2/05) (2-1), *motion for rehearing en banc denied,* 2006 U.S. App. LEXIS 8294 (6th Cir. 3/30/06). Federal excise tax on long-distance calls does not apply unless the charges vary based upon both time and distance. The majority opinion held that "and" means "and" but the dissent argued that "and" could also mean "or." When this three percent tax on toll telephone calls was enacted in 1965, there was only one long-distance telephone provider and its charges were based upon both the distance and time of the call [or on a flat rate for unlimited calling on a WATS line, to which the tax also applied]. The majority held that a literal reading of the statute was required because a tax should only apply to that which its language taxes. The dissent would "not encourage lawyers to play word games at the expense of the public fisc."

b. **The IRS takes a hard line.** Notice 2005-79, 2005-46 I.R.B. 952 (11/14/05). The IRS will continue to litigate this issue and will continue to assess and collect the § 4251 tax on long distance communications services.

c. **Amtrak's long-distance telephone service is not subject to the excise tax on toll telephone services because the payment was based solely on time.** National Railroad Passenger Corp. (Amtrak) v. United States, 431 F.3d 374 (D.C. Cir. 12/9/05). The court affirmed the district court and concluded that the statute was unambiguous, and the "and" in § 4252 was to be read conjunctively.

d. **The Second Circuit agrees that the telephone excise tax does not apply.** Fortis Inc. v. United States, 447 F.3d 190 (2d Cir. 4/27/06) (per curiam).

e. **So does the Third Circuit in a lengthy analysis of the meaning of the word "and" and a shorter analysis of the meaning of the word "distance."** Reese Brothers, Inc. v. United States, 447 F.3d 229 (3d Cir. 5/9/06).

f. **"Enough, already!" The IRS cries, "Uncle."** Notice 2006-50, 2006-25 I.R.B. 1141 (5/25/06), *revoking* Notice 2005-79, 2005-46 I.R.B. 952. The IRS announces that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling overassessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

g. **IRS announces safe harbor amounts for telephone tax refunds.** On 8/31/06, the IRS announced the safe harbor refund amounts of telephone tax available to individual taxpayers [without records or other proof of actual amounts paid] are $30 for individual filers, with a $10 increase for each additional exemption claimed on the 2006 return, up to a maximum of $60. 2006 TNT 170-2.

XII. TAX LEGISLATION

A. Enacted

1. The **Energy Policy Act of 2005**, P.L. 109-58, was signed by President Bush on 8/8/05. Title XIII (Energy Policy Tax Incentives) of the Energy Policy Act of 2005 may also be cited as the **"Energy Tax Incentives Act of 2005."**

- This $14.5 billion tax legislation creates a list of tax breaks for consumers who install qualified energy-efficient devices in their homes or buy qualified energy-efficient vehicles. The Energy Act also provides the business community with new targeted tax deductions and credits for qualified energy-related expenditures. **Businesses that will most likely benefit are: 1)** a business that installs qualified energy-efficient equipment in its commercial building, **2)** a contractor that constructs qualified energy-efficient homes, **3)** a company that manufactures certain energy-efficient appliances, **and 4)** energy companies that incur qualified expenditures to improve the infrastructure for supplying energy to consumers or that increase their energy production capabilities.

- Individuals and businesses must satisfy specific requirements to qualify for these tax breaks. Many of these rules are detailed and complex. The credits that target consumers are generally not phased out at the higher income levels. However, these credits are not generally allowed to reduce the alternative minimum tax (AMT). Thus, if someone anticipates being hit by the AMT in the year assets qualifying for the energy credit are placed-in-service, the tax benefit of these new energy tax breaks could be diminished, or eliminated altogether.

- Generally, **the effective date of these new benefits** is for qualified energy-efficient property **"placed-in-service" after December 31, 2005.** This outline highlights the effective dates for each new tax break to help you determine when each benefit is available. **"Placed-in-service"** generally **means** that the property is in a condition or state of readiness for a specifically-designed function. In other words, property is placed-in-service when it is **ready and available for use.**

2. The **Highway Reauthorization and Excise Tax Simplification Act of 2005**, P.L. 109-59, was signed by President Bush on 8/10/05.

3. **Kiss Me Kate.[3] Or, is it the powerful Katrin(k)a?[4]** The **Katrina Emergency Tax Relief Act of 2005** ("KETRA" or "Katrina Tax Act"), P.L. 109-73, was signed by President Bush on 9/23/05.

4. **The Gulf Opportunity Zone Act of 2005** (**"GO Zone Act"**), P.L. 109-135, was signed by President Bush on 12/21/05. The Act: (1) provides 50 percent bonus depreciation to businesses rebuilt in the newly created Gulf Opportunity (GO) Zone; (2) doubles the amount that may be expensed under § 179 from $ 100,000 to $ 200,000 for investments made in the GO Zone and increase the phaseout floor from $ 400,000 of annual investments to $ 1 million; (3) allows businesses a five-year carryback of net operating losses attributable to investment in the GO Zone; (4) increases the amount of expensing allowed for reforestation costs of small timber owners within the GO Zone and within the areas affected by Hurricane Rita; (5) increases and enhances low-income housing credits within the GO Zone; (6) increases the rehabilitation tax credit for qualified expenditures within the GO Zone; (7) increases the cap on new markets tax credits and allocate the increased amounts to entities making low-income community investments in the GO Zone; and (8) creates additional tax-exempt bond authority for states and municipalities within the GO Zone and allow those states to issue debt service tax credit bonds to help devastated communities meet their debt service requirements as a result of the hurricanes.

5. The **Tax Increase Prevention and Reconciliation Act of 2005** (*sic*) (**"TIPRA"**), Pub. L. 109-222, was signed by President Bush on 5/17/06.

[3] For Cole Porter devotees.
[4] For readers of the old Toonerville Trolley comic strip.

6. **Heroes Earned Retirement Opportunities Act ("HERO Act")**, Pub. L. 109-227, 120 Stat. 385, was signed by President Bush on 5/29/06.

7. The **Pension Protection Act of 2006 ("Pension Protection Act")**, P.L. 109-280 was signed by President Bush on 8/17/06. The bill:

- Makes permanent provisions in a 2001 tax cut law that raised annual contribution limits for IRAs.
- Ends the legal uncertainty surrounding cash balance pension plans, which have run into legal challenges from employees who have claimed that older workers lose out when employers switch from traditional defined-benefit plans.
- Permits qualified financial firms that manage investment firms to offer face-to-face investment advice to help employees manage 401(k) and other retirement options.
- Contains the charitable provisions that had been in the estate tax bill.

8. **A state may not tax nonresident partners on retirement income that is sourced in that state.** P.L. 109-264, which amends 4 U.S.C. § 114(b)(1) to limit state taxation of nonresidents on retirement income paid to partners on account of their in-state services performed during the years the retirement income was accrued, was enacted on 8/3/06. The provision was enacted in response to New York's attempt to tax retirement income of partners based on the position that 4 U.S.C. § 114 applied to the retirement income of nonresident employees, and not partners.

B. Pending

1. H.R. 5638, the Permanent Estate Tax Relief Act of 2006, was approved by the House on 6/22/06 by a vote of 269-156. It failed to receive 60 votes in the Senate on 8/3/06.