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Recent Developments in Federal Income Taxation

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I. ACCOUNTING

A. Accounting Methods

1. ***Pharmaceuticals administered by physicians are not merchandise; they're supplies used in connection with the rendering of services.** Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner, 113 T.C. 376 (11/22/99) (reviewed, 11-6). Chemotherapy drugs administered by a cash-method professional medical corporation were not merchandise under Reg. § 1.471-1, so inventory accounting and a hybrid method [accrual method for the chemotherapy drugs and cash method for the balance of taxpayer's business] were not required. Generally, goods sold by a service provider ancillary to the provision of services must be inventoried and accounted for under the accrual method. See *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79, *aff'd,* 420 F.2d 352, 70-1 U.S.T.C. ¶9173 (1st Cir. 1970) (undertaker's supply of caskets); Rev. Rul. 74-279, 1974-1 CB 110 (optometrist's supply of glasses and frames). But "giv[ing] significance to the uniqueness of the industry ... in relation to other service industries," the Tax Court, in a reviewed opinion by Judge Laro, has carved out a special exception for pharmaceuticals – in this case, medicines administered in course of chemotherapy cancer treatments – furnished by a physician (or hospital) provided as "an integral, indispensable, and inseparable part of the rendering of medical services." The Tax Court, has held that such a transaction is not a "sale of 'merchandise,'" even if the items involved are very expensive [charges for the drugs constituted 26 percent of taxpayer's gross receipts and were separately invoiced] and thus represent a significant portion of the transactions. Accordingly, such pharmaceuticals need not be inventoried and accounted for (with the taxpayer required to shift to the accrual method), but are supplies that can be expensed under §162. The Commissioner abused his discretion in requiring the medicines to be treated as inventory subject to the accrual method when the taxpayer otherwise used the cash method. A critical factor in this result, however, was that the pharmaceuticals could not have been purchased from the taxpayer separately from the associated medical services. The court also noted that the taxpayer kept only a two-week supply.

- In *Hospital Corp. of America v. Commissioner*, 107 T.C. 116 (1996), the Tax Court held that a cash method hospital was not required to use accrual method to account for medical supplies dispensed to patients in course of hospital stay, but did not reach the inventory question.
- A dissent by Judge Halpern criticized the majority opinion for, among other things, overturning the Commissioner's discretion in an accounting methods case in which the taxpayer failed to demonstrate that its accounting method clearly reflected income [an issue which Judge Halpern correctly notes was not addressed in the majority opinion]. The dissent further asserted that Reg. §1.162-3 mandates that the deduction for supplies on hand should he made only as "they are actually consumed and used in operation during the taxable year," as opposed to "incidental materials or supplies on hand, for which no record of consumption is kept," which may be currently deducted. Judge Halpern relies on *Wilkinson-Beane Inc. v. Commissioner*, 420 F.2d 352, 70-1 U.S.T.C. ¶9173 (1st Cir. 1970), aff'g T.C. Memo. 1969-79 (funeral home in service business has merchandise when it derives a substantial part of income from the regular purchase and sale of tangible personal property).

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a. **Play it again.** Mid-Del Therapeutic Center, Inc. v. Commissioner, T.C. Memo 2000-131 (4/11/00). On facts essentially the same as those in *Osteopathic Medical Oncology and Hematology, P.C.*, the court reached the same result.

b. ***And the IRS acquiesces in the result.** AOD. 2000-05 (4/27/00). The IRS acquiesces in the result in *Osteopathic Medical Oncology and Hematology, P.C.*, and agrees that under circumstances comparable to this case, prescription drugs or similar items administered by healthcare providers are not merchandise under Reg. §1.471-1. The AOD notes, however, that Reg. §1.162-3 may require a similarly situated health care provider to treat the cost of prescription drugs or similar items as deferred expenses that are deductible only in the year they are used or consumed.

2. ***Nor is ready-mixed concrete merchandise held for sale by a contractor.** RACMP Enterprises, Inc. v. Commissioner, 114 T.C. No. 16 (3/20/00) (reviewed, 10-6). The taxpayer was a construction contracting company that constructed concrete foundations, driveways, and walkways. The Tax Court (in reviewed opinion 10-6, by Judge Parr) rejected the Commissioner's attempt to compel the taxpayer to switch from the cash method to the accrual method and permitted the taxpayer to use the cash method to account for its income and expenses for the cost of ready-mix liquid concrete and other materials. The materials were used up before they were paid for and before the taxpayer reported their expense. Like the road contractor in *Galedrige Construction, Inc. v. Commissioner*, T.C. Memo. 1997-240 (5/22/97), who was permitted to use the cash method for purchases and sales of emulsified asphalt in connection with road building contracts, RACMP was in the business of providing services, not of selling merchandise, and that the ready-mix concrete material was an indispensable and inseparable part of the provision of that service. Fill sand, drain rock, and hardware were not as "ephemeral" as the liquid concrete, but also were indispensable to and inseparable from the services provided by RACMP, even though a *de minimis* amount often remained on hand at the end of a contract. Reg. §1.471-1 does not provide that any materials that are an income producing factor are *ipso facto* merchandise, citing *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner.*

- "[W]here a taxpayer is a "small" corporation permitted to use the cash method under section 448(b)(3), is not required to maintain an inventory, consistently used the cash method of accounting since its incorporation, and has made no attempt to unreasonably prepay expenses or purchase supplies in advance, the taxpayer is not required to show a substantial identity of results between the taxpayer's method of accounting and the method selected by the Commissioner."
- Judge Gerber vigorously dissented on numerous grounds: (1) Taxpayer did not meet the heavier-than-normal burden of showing an abuse of the Commissioner's discretion; (2) the majority's conclusion that the materials involved were merely an inseparable part of petitioner's performance of a service was not supported by the record; (3) the majority's holding and approach may result in unintended preferential tax treatment for a particular industry and/or taxpayers dealing in so- called "ephemeral" products or materials; (4) the holding in Galedrige Construction, Inc. was erroneous and the majority's reliance upon it thus unfounded; and (5) the RACMP case was factually distinguishable from Osteopathic Medical Oncology & Hematology, P.C.
- The essence of Judge Halpern's dissent is captured in the following:

> Restaurants do not sell tobacco products anymore, and liquor may give them pause, but can fancy French restaurants (or large food service operations) now argue that they need not inventory their comestibles since they are inherently a service business, with peas, carrots, truffles, and boeuf being integral to that service? What about the proliferation of dot.com businesses, whose added value is generally some service, such as the ability to shop at home for merchandise, such as books or music, that used to require a trip to the store? I fear that our new rule may be misunderstood.

3. Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner, T.C. Memo 2000-114 (3/21/00). The Commissioner did not abuse his discretion in requiring a sand and gravel trucking company that purchased and resold sand and gravel to switch from the cash to the accrual method because the taxpayer primarily sold sand and only incidentally transported it. *RACMP Industries, Inc.* was distinguishable.

4. Jim Turin & Sons, Inc. v. Commissioner, 219 F.3d 1103, 2000-1 U.S.T.C. ¶50,610 (9th Cir. 7/21/00). Affirms Tax Court decision that Commissioner abused his discretion in requiring paving company to change from the cash method to the accrual method, reasoning asphalt is not

susceptible to being inventoried. Follows *Galedridge Constuction Inc. v. Commissioner*, T.C. Memo. 1997-240 and *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. No. 16 (3/30/00), and distinguishes *Von Euw & Nunes Trucking, Inc. v. Commissioner*, T.C. Memo. 2000-114 (3/21/00).

5. Yet another construction company is allowed to use the cash method. Is the IRS is aiming for a split in the circuits after the dust settle on the first round of appeals? Vandra Bros. Construction Co., Inc. v. Commissioner, T.C. Memo 2000-233 (8/2/00). *RACMP Enterprises* was followed on "indistinguishable" facts.

6. IRS ends the small-dollar aspect of its crusade against the cash method, but continues the crusade against "small" taxpayers with gross receipts between $1million and $5 million. Rev. Proc. 2000-22, 2000-20 I.R.B. 1008 (4/28/00). The Commissioner will exercise his discretion to except a "qualifying taxpayer," i.e., one with average annual gross receipts of $1 million or less [as determined under Reg.§1.448-1T(f)(2)(iv), from the requirements of accounting for inventories and using an accrual method of accounting for purchases and sales of merchandise. A business that adopts the cash method under this revenue procedure will treat inventory items as materials and supplies that are *not* incidental under Reg. §1.162-3. This means that the taxpayer must capitalize the cost or actual purchases of goods or materials to be resold or incorporated into manufactured products and offset the capitalized amounts against the amount realized when the goods are resold, but the taxpayer may deduct currently all other manufacturing and handling costs (including labor, warehousing, and other direct and indirect costs that normally must be capitalized under §263A). To qualify, the business may not use any method other than the cash method for its books and records and other reports. An automatic change in accounting method to the cash method under Rev. Proc. 2000-22 is available under Rev. Proc. 99- 49, 1999-52 I.R.B. 725. Rev. Proc. 2000-22 is effective for tax years ending after December 16, 1999.

- **Tax professionals still not happy!** Many members of the Bar and of the accounting profession, as well as industry representatives, believe that the $1,000,000 ceiling is too low and want the IRS to announce a $5,000,000 annual gross receipts safe-harbor for an automatic cash method with no inventories.

B. Inventories

1. New §1221(a)(8), enacted in 1999, excludes from capital asset treatment supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer. See III.A., below.

2. REG-107644-98, proposed regulations under §472, relating to changes in the inventory price index computation of LIFO dollar-value inventory pools (65 F.R. 31841, 5/12/00).

C. Installment Method

1. **Tax Relief Extension Act of 1999** amended §453 by adding new §453(a)(2) denying accrual method taxpayers the privilege of installment reporting on any sales of property whatsoever. Even though the taxpayer uses the accrual method, however, §453(a)(2) does not disallow the installment reporting under §453(l) for dispositions of property used or produced in the trade or business of farming or dispositions of residential lots or time-share condominium units.

- The legislative history explains the purpose of this change by stating that:

> The installment method is inconsistent with the use of the accrual method of accounting and should not be allowed in situations where the disposition of property would otherwise be reported using the accrual method. The Committee is concerned that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.

- Although this language may sound like Congress had installment sales of goods in the ordinary course of business in mind in enacting the provision, the legislative history specifically notes that under pre-1999 §453 "[s]ales to customers in the ordinary course of business" were not eligible for the installment method. Thus, it is reasonably clear that the sales Congress had in mind were asset sales other than in the ordinary course of business. Accordingly, the installment method under §453 is no longer available to report the disposition of §1231 property or capital assets used in the trade or business of an accrual method taxpayer.

- For example, if a hardware store business, consisting of inventory, accounts receivable, equipment, land and building, and goodwill is sold "lock, stock, and barrel" for a lump sum payment due in 5 years, the entire gain on all of the assets (which must be computed separately on each asset) must be reported in the year of the sale, even though under prior law the sales of the equipment (except to the extent of §1245 recapture), land, building, and goodwill (except to the extent of §1245 recapture if the goodwill was a §197 amortizable intangible) could have been reported on the installment method.

a. ***Guidance on application of denial of installment method to accrual method taxpayers.** Notice 2000-26, 2000-17 I.R.B. 954 (4/24/00). This notice provides guidance in a Q&A format regarding the application of §453(a)(2).

- Cash method shareholders of an accrual method corporation may report sales of stock under the installment method, regardless of whether the purchaser makes a §338(g) election.

- Cash method shareholders of an accrual method S corporation may not report under the installment method if a joint §338(h)(10) election has been made.

- Cash method partners of an accrual method partnership may report the sale of a partnership interest on the installment method [subject to the limitations of §453(i)(2) and Rev. Rul. 89-108, 1989-2 C.B. 100.

- Even if an installment obligation provides for contingent payments, an accrual method taxpayer generally may not use the open transaction method of *Burnet v. Logan*, 283 U.S. 404 (1931) to report the gain. Open transaction reporting is available only in those rare and extraordinary cases in which the fair market value of the obligation cannot reasonably be ascertained. See Reg. §§1.1001-1(a) and (g); 1.483-4 and 1.1275-4 [for rules concerning the taxpayer's treatment of the installment obligation].

2. The **Tax Relief Extension Act of 1999** also amended §453A(d) to apply the "pledge as recognition" rule whenever a taxpayer holding an installment obligation has the right to satisfy all or any portion his own debt to any creditor by transferring the installment obligation.

- Unless one of the various special exceptions applies, both the seller and buyer report the OID on the accrual method. Any gain on the sale of the property itself is reported by an accrual method taxpayer in its entirety in the year of the sale and by a cash method taxpayer either currently or using the installment method under §453 if the sale is eligible for installment reporting under that Code provision.

D. Year of Receipt or Deduction

1. ****Boylston Market*[1] **still reigns. USFreightways Corp. v. Commissioner, 113 T.C. 329 (11/2/99). Accrual method trucking company must capitalize expenditures for licenses and insurance which had an effective period extending beyond the tax year. Judge Nims held that taxpayer's argument – whether or not the argument is well-taken – that the expenditures should be currently deductible if their benefit extends "less than 12 months into the subsequent tax period" is inapplicable to an accrual method taxpayer.

2. Schlumberger Technology Corp. v. United States, 195 F.3d 216, 99-2 U.S.T.C. ¶50,957, 84 A.F.T.R.2d 6866 (5th Cir. 11/5/99). The taxpayer was not required to accrue a Swiss arbitral award until the period for appeal had expired. Under Swiss law, and arbitral award required judicial confirmation before becoming enforceable and the unappealed award was not judicially confirmed until the period for appeal had lapsed.

3. Exxon Mobil Corp. v. Commissioner, 114 T.C. No. 20 (5/3/00). Taxpayer's 22-percent share of estimated dismantlement, removal, and restoration costs of $928 million related to

[1] 131 F.2d 966 (1st Cir. 1942).

Prudhoe Bay oil field production equipment and facilities are not sufficiently fixed and definite to be accruable under the Reg.§1.461-1(a)(2) all-events test. Judge Swift further held that taxpayer's share of $111 million in estimated DDR costs relating specifically to oil wells and to well drilling sites are sufficiently fixed under the all-events test. However, the costs are not accruable as a capital cost because that would constitute an accounting method change for which taxpayer has not received permission, nor are they accruable as a current expense because this would cause a distortion in taxpayer's income.

4. **Clinton tax increase claims another casualty.** Thomas v. United States, 2000-1 U.S.T.C. ¶50,496 (6th Cir. 5/26/00). Affirms district court summary judgment that "Cash Option" lottery winner had income in the later year when prize was verified (1993), not [under the "economic benefit" doctrine] in the earlier year in which the ticket was drawn and taxpayer claimed the prize (1992). It took approximately six weeks to process taxpayer's claim. The court found that taxpayer did not have irrevocable rights in any specific fund in 1992 that were greater than general creditors of the fund.

5. American Express Co. v. United States, 2000-1 U.S.T.C. ¶50,575, 86 A.F.T.R.2d 5217 (Fed. Cl. 6/20/00). Before 1987, taxpayer included annual credit card fees in income when the fees were billed. In 1987 taxpayer changed its method of accounting on the basis of FASB 91 to include the fees ratably over the 12-month period for which they were billed and sought the Commissioner's approval for the change in accordance with Rev. Proc. 71-21, 1971-2 C.B. 549. The court held the Commissioner's denial of the request to be within his discretion on the ground that Rev. Proc. 71-21 and G.C.M. 39434 (10/25/85) provide an adequate basis for the determination that the fees were not for services. The G.C.M. viewed card fees as payments for credit, not as payments for "contingent services."

- The Court of Federal Claims held that *Barnett Banks of Florida v. Commissioner*, 106 T.C. 103 (1996) (allowing ratable inclusion of refundable credit card fees) was decided on its own facts [which are, in fact, difficult to distinguish] and did not as a mater of law require overturning the Commissioner's discretion in this case. The court further noted that the *Barnett Banks* court did not "fully address[] the question of whether there was an adequate basis for the Commissioner's exercise of discretion under Rev. Proc. 71-21" and that the Court of Federal Claims will not make close factual judgments where there is no abuse of discretion.

6. Midamerican Energy Co. v. Commissioner, 114 T.C. No. 35 (6/30/00). Section 1341 does not apply to rate reductions by public utility to indirectly compensate customers for prior charges that retrospectively were determined to have over-recovered costs and therefor to have been excessive; rate reductions were income reductions, not deductible expenses, and amounts and benefited customers depended on current consumption, not consumption in year of overcharges). Accord *Florida Progress Corp. v. Commissioner*, 114 T.C. No. 36 (6/30/00).

7. Tutor-Saliba Corp. v. Commissioner, 115 T.C. No. 1 (7/17/00). Holds valid Reg. §1.460-6(c)(2)(vi), which provides that under the percentage of completion method, the "estimated contract price" includes amounts related to contingent rights (i.e., incentive fees or amounts in dispute) and liabilities that have a "reasonable expectancy" of occurring – whether or not the all events test has been met – because the regulation "harmonizes with the plain language, origin, and purpose of section 460." Taxpayer argued that the all events test is a fundamental tax principle that cannot be ignore without an express mandate from Congress, but Judge Gerber rejected the argument because "the section 460 version of the percentage of completion method is a self-contained, statutorily created form of accounting method which varies substantially from prior accrual accounting methodology . . . ."

8. **You might not be able to have your cake and eat it too, but you can take your accrual deduction and hold back payment of the cash.** Newhouse Broadcasting Corp. v. Commissioner, T.C. Memo. 20000-244 (8/7/00). Taxpayer's Random House subsidiary was contractually obligated to pay book authors royalties on all books sold and not returned, even if payment was never received. Random House accrued deductions for royalties on all books sold in the year. It did not pay authors royalties on all books sold but set up a "reserve" against returns and held back payment for the portion of the royalties attributable to books expected to be returned. The Tax Court (Judge Halpern) rejected the Commissioner's argument that this practice negated satisfaction of the all events test with respect to the amount of royalties equal to the additions to the reserve and not paid. The royalties were legally "owed" to the authors until the books were returned, which was a subsequent event, even if they were not yet payable and might never be payable due to those subsequent events.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Estate of Smith v. Commissioner, 110 T.C. 12 (1/12/98). Algerine Smith, Frankie Allen and Jessamine Allen owned oil royalty interests. When Jessamine died in 1979, Algerine Smith inherited Jessamine's interest; when Frankie died in 1989, Algerine Smith inherited a portion of Frankie's interest. In 1988, Exxon sued Algerine (and others) to recover a portion of royalties paid to Algerine Smith, Frankie and Jessamine Allen (and others) from 1975 through 1980. After Algerine dies in 1990, Algerine's estate settled the claims against Algerine, Frankie, and Jessamine. The estate claimed the benefit of §1341 with respect to the repayment. The Tax Court held that the estate could apply §1341 only to the repayment of the claims against Algerine. Section 1341 does not apply to repayments of amounts received by and taxed to the taxpayer's predecessor in interest. Repayments by a beneficiary of an estate of amounts received by and taxed to the decedent and inherited by the beneficiary are not subject to §1341.

a. ***Affirmed and reversed,** 198 F.3d 515, 99-2 U.S.T.C. ¶60,366, 84 A.F.T.R.2d 7397 (5th Cir. 12/15/99). The value of a reimbursement claim against an estate should not have been limited to a post-death settlement, but should have been determined as of the date of the decedent's death. Judge Weiner further held that the income tax benefit the estate derived under §1341 for its settlement payment was not a separate estate asset, and that the estate did not have COD income by settling the claim for less than the amount deducted under §2053.

- The Fifth Circuit addressed the issue of whether an estate realizes discharge of indebtedness income when it settles a claim for less than the amount deducted on the estate tax return under §2053(a)(3). The particular claim in that case was a claim by Exxon, which was pending at the time of the decedent's death, that it was entitled to recoup a portion of the royalties that it previously had paid to the decedent under a mineral lease. The court rejected the Commissioner's argument that discharge of indebtedness income result from the settlement, holding that both the fact of the liability and its amount were not determined until the case was settled, and that it therefore did not have to choose between the *Darin* and *Presale* approaches to the scope of the contested debt doctrine.

(1) IRS non-acquiesced in Fifth Circuit Smith decision on the estate tax issue, 2000-19 I.R.B. 962.

2. **Final regulations on curbing the whipsaw potential of §110 also make clear that people like us tax professionals are retailers and that back-office and storage spaces are included.** T.D. 8901, Qualified Lease Construction Allowances for Short Term Leases, 2000-38 I.R.B. 272 (65 F.R. 53584, 8/29/00). Final regulations under §110 relating to the exclusion for gross income for qualified lease construction payments provided by a lessor to a lessee for the purpose of constructing long lived improvements pursuant to a short-lived lease. The regulations impose information reporting requirements on both the lessor and lessee. They also clarify the definition of "retail space" to include offices for hair stylists, insurance agents, stock brokers, bankers, doctors, lawyers, and other professionals. They further clarify that back office spaces are included, as well as the selling floor.

a. REG-106010-98, proposed regulations on the safe harbor under §110 [added in 1997], which allows a lessee in a short-term lease of retail apace to exclude from income construction allowances it uses to construct qualified long-term property (64 F.R. 50783, 9/20/99). The safe harbor defines "qualified long-term real property" as nonresidential real property which is part of the rental space and which reverts to the lessor at the termination of the lease. It defines "short-term lease" as a lease for retail space for 15 years or less. "Retail space" is defined as real property used by a lessee in its trade or business of selling tangible personal property or services to the general public.

3. Rev. Proc. 2000-33, 2000-36 I.R.B. 257 (9/5/00). The acquisition of corporate debt by a beneficiary of a decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death where the beneficiary of the estate is related to the corporate debtor, the decedent creditor was also related to the corporate debtor, but the estate or trust is not related to the corporate debtor is not an indirect acquisition of the debt by the corporation under Reg. §1.198-2(b) triggering COD income to the corporation under §108(e)(4).

B. Deductible Expenses versus Capitalization – **INDOPCO* aftermath: "Deductions are exceptions to the norm of capitalization." (Blackmun, J.)

1. Is Rev. Rul 94-38 all it's cracked up to be? Dominion Resources, Inc. v. United States, 48 F. Supp. 2d 527, 99-1 U.S.T.C. ¶50,369, 83 A.F.T.R.2d 1350 (E.D. Va. 3/5/99). The taxpayer incurred environmental remediation expenses to remove asbestos and other contaminants from a site previously used as a power generating station for purpose of preparing the site of the retired power plant for use as an office building site or for sale. Rev. Rul. 94-38, 1994-1 C.B. 35, generally allows a deduction for environmental remediation costs to remedy the taxpayer's own prior pollution. Notwithstanding the Ruling, the taxpayer was required to capitalize the expenditures because it did not merely maintain the property, but increased the appraised value of the property from approximately $1.5 million to approximately $9 million and prepared it for a new or different use. Rev. Rul. 94-38 was inapplicable because the site was no longer used as a power generating station, nor was such use in the future contemplated by taxpayer.

a. **Dominion Resources* affirmed. Dominion Resources, Inc. v. United States, 219 F.3d 359, 2000-2 U.S.T.C. ¶50,633 (4th Cir. 7/19/00). The cleanup costs permitted the property to be utilized in a different way so the improvement is considered a capital expenditure – as opposed to an improvement that only restores value to the property that existed prior to the deterioration [or prior to a discrete event that damaged the property], which is treated as a deductible repair expense. The cleanup altered the character of the property, enabling the property to be put to "a wide range of new uses" – as opposed to keeping the property in its ordinary efficient condition.

b. *IRS rules contra to *Dominion Resources*; cleaning up after yourself is currently deductible. TAM 199952075 (8/28/99). Restoration costs allocable to contamination that occurred during taxpayer's ownership and operation of a manufactured gas plant are currently deductible under §162 and Reg. §1.162-4 because these costs merely restored the site to the condition that existed at the time taxpayer acquired the property. The ruling also stated that the plan of rehabilitation doctrine did not apply because of taxpayer's construction of a new building on the site because "these remediation costs merely are restorative in nature, [and] they do not adapt the property to a new or different use. . . . [they] were not directly related to the construction of the building [but] "to the restoration of the land, an asset separate and apart from the new building."

c. United Dairy Farmers, Inc. v. United States, 107 F. Supp. 2d 937, 2000-1 U.S.T.C. ¶50,538, 85 A.F.T.R.2d 2235 (S.D. Ohio 5/23/00). Taxpayer incurred environmental remediation expenses to clean-up pollution caused by prior owners who operated gas stations on the site of a convenience store. Even though the taxpayer was unaware of the pollution at the time of the purchase and thus "overpaid" for the property, the expenses were required to be capitalized because they "increased the value of the property." Rev. Rul. 94-38 did not apply.

d. A definitive, but less-than-comprehensive, post-*INDOPCO* revenue ruling. Rev. Rul. 94-38, 1994-25 I.R.B. 4 (6/2/94). This ruling addresses soil remediation and groundwater treatment costs attributable to pollution caused by the taxpayer, and does not apply to costs attributable to pre-ownership contamination or to costs other than soil remediation and groundwater treatment. It relies upon *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), which held that costs incurred to restore taxpayer's property to essentially the same condition that existed prior to the contamination were deductible under §162. The ruling holds that environmental cleanup costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business (other than costs attributable to the construction of groundwater treatment facilities) are deductible under §162 as ordinary and necessary business expenses. The cost of construction groundwater treatment facilities must be capitalized under §§263 and 263A. This ruling applies whether the taxpayer plans to continue its manufacturing operations that discharge the hazardous waste or to discontinue those manufacturing operations and hold the land in an idle state, but it does not apply to costs incurred in anticipation of sale of the land. This ruling supersedes TAM 9315004 (12/17/92), which required capitalization of cleanup costs for land contaminated with PCBs.

2. Extending expensing of certain environmental remediation costs. As originally enacted in 1997, §198 "expensing of environmental remediation costs . . . which [are] paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site " applied only to expenditures paid or incurred between 8/5/97 and 12/31/00. In 1999, Congress extended the provision's sunset date to 12/31/01.

3. ***The cost of an attorney's "long tail" malpractice policy was deductible in full in the year in which he retired from the practice of law.** Steger v. Commissioner, 113 T.C. No. 18 (10/1/99). Taxpayer retired from his private law practice in 1993 and purchased a non-practicing malpractice insurance policy, which provided coverage for an "indefinite period of time" for professional services rendered before taxpayer's retirement. The Commissioner determined that the policy is a capital asset providing a substantial future benefit, and under *INDOPCO* must be capitalized; the Commissioner allowed amortization deductions over ten years. Held, taxpayer is entitled to deduct the entire cost of the policy in 1993 because it is an ordinary and necessary expense in connection with the closing of his business.

4. ***ISO costs OK.** Rev. Rul. 2000-4, 2000-4 I.R.B. 331 (1/24/00). Cost incurred by a taxpayer to obtain, maintain, and renew ISO 9000 [a series of international standards for quality management systems developed by the International Organization for Standardization (ISO) comprised of several specific requirements that are intended to ensure a quality process in providing services or products to an organization's customers] certification are deductible as ordinary and necessary business expenses under §162 except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual). *INDOPCO* does not require capitalization of all such expenses because ISO 9000 certification is neither a separate and distinct asset nor does it result in future benefits that are more than incidental. The benefits are akin to those from training and advertising. Moreover, the mere fact that the certification facilitates expansion of the existing business does not require capitalization.

- Note that the ruling compares as different types of situations, the expenditures in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), which it notes were deductible, and those in *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), which it notes were not deductible, apparently citing *Briarcliff Candy* with approval, notwithstanding the Tax Court's holding in *Norwest v. Commissioner*, 112 T.C. 89 (1999), *rev'd sub nom. Wells Fargo & Co. v. Commissioner*, 2000-2 U.S.T.C. ¶50,697 (8th Cir. 2000), that *INDOPCO* had *sub silentio* overruled *Briarcliff Candy*.

5. **And the IRS never mentioned *INDOPCO* in this pro-taxpayer ruling.** Rev. Rul. 2000-7; 2000-9 I.R.B. 712 (2/8/00). The IRS allowed a current deduction for the cost or removing old telephone poles as part of project to replace the poles supporting a line with new poles. The removal costs related to the retired assets, not to installation or construction of the new assets, and neither §263 nor §263A applied. Nor did §280B apply [because the telephone poles were not "buildings"].

> The analysis in this ruling does not apply to the removal of a component of a depreciable asset, the costs of which are either deductible or capitalizable based on whether replacement of the component constitutes a repair or an improvement. See section 1.162-4 and section 1.263(a)-1(b).

6. **He who live by the [financial accounting] sword will die by the [tax] sword.** PNC Bancorp, Inc. v. Commissioner, 110 T.C. 349 (6/8/98). Banks' loan origination expenditures were incurred in the creation of loans, which were separate and distinct assets that generated revenue over a period beyond the current taxable year. Judge Ruwe held the expenditure must be capitalized. Taxpayer had argued that they were recurring expenses, so deductible. However, these costs were capitalized for financial accounting purposes, and amortized over the life of the loans, in accordance with SFAS 91 [relating to deferral of loan origination (1) "incremental direct costs" and (2) certain costs related to specified activities of the lender].

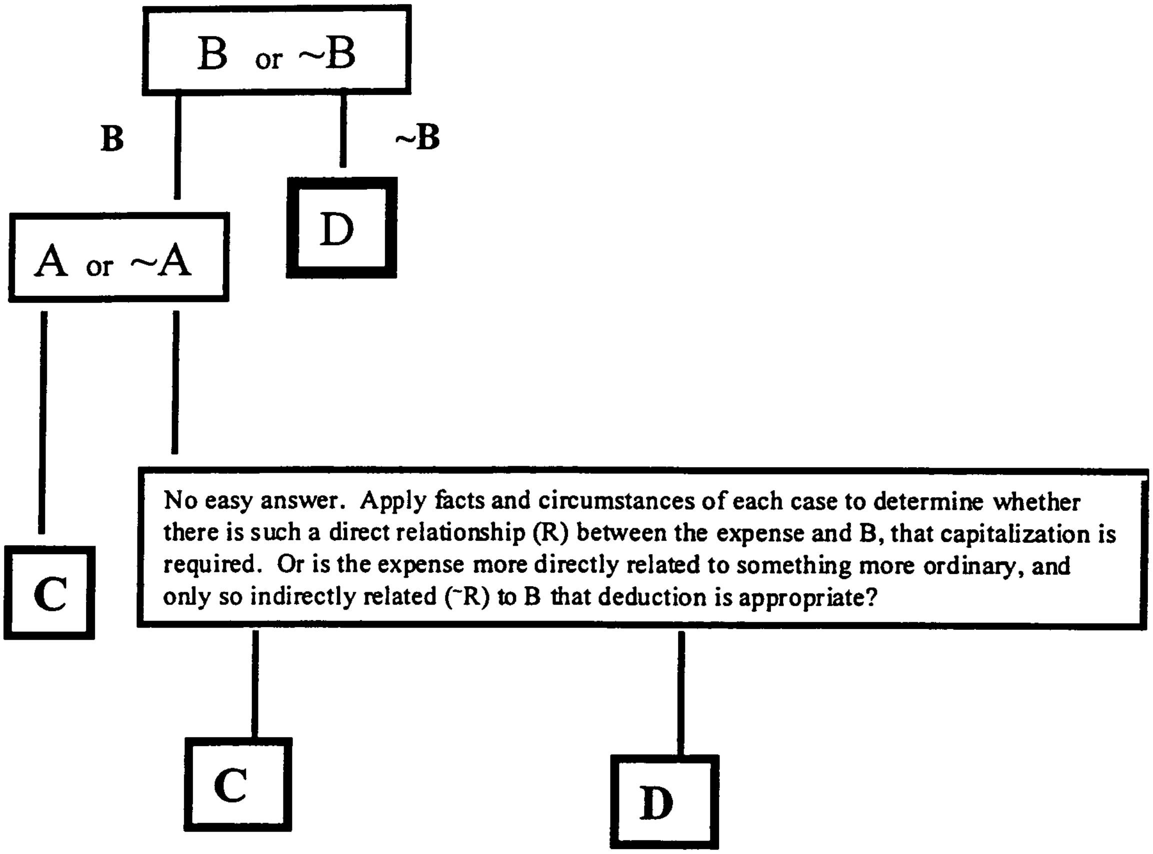
a. ****PNC Bancorp* reversed. Consumer and commercial loans are not "separate and distinct assets," because loan revenue was the bank's largest revenue source and costs of originating loans were normal costs of doing business.** PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822, 2000-1 U.S.T.C. ¶50,483, 85 A.F.T.R.2d 1554 (3d Cir. 5/19/00), *rev'g* 110 T.C. 349 (1998). The Court of Appeals for the Third Circuit reversed the Tax Court's decision in *PNC Bancorp* and allowed a current deduction. Judge Rendell court reasoned that the loans in question were not "separate and distinct assets" because loan revenue was the bank's largest revenue source. Origination costs thus were merely the normal and routine costs of doing business that did need have to be capitalized. The opinion distinguished *Lincoln Savings* on the grounds that the "Secondary Reserve fund," to which Lincoln Savings made the payments and which was the separate asset in that case, existed wholly apart from Lincoln Savings' business and that PNC's origination activities did not "create" the loans in the way Lincoln Savings' payments created the Secondary Reserve fund because PNC's payments did not become part of the balance of the loan. The court relied on the bank credit card cases [*Colorado Springs Nat'l Bank v. United States*, 505 F2d 1185, 1190 (10th Cir. 1974); *Iowa-Des Moines Nat'l Bank v. CIR*, 592 F2d 433 (8th Cir. 1979)], which allowed a current deduction for the expenses incurred by banks to initiate bank credit card lending activities, which the court of appeals concluded continue to have vitality after *INDOPCO*. The court then went on to find that *INDOPCO* itself was not controlling to require capitalization because the future benefit test was not intended by the Supreme Court to be talismanic in all cases. Although the loans themselves may have had lives of several years, the information obtained by the bank as a result of the original fees had a relatively short life — it was not a "permanent betterment or improvement" in the statutory language of §263(a). And there was no concern regarding distortion of income because of the recurring nature of the expenses.

- See footnote 17 for an analysis that capitalization only of successful loan costs was nonsensical, noting that it would mean that only that successful R&D costs need be capitalized.
- While there might be some merit to the Third Circuit's points that consumer and commercial loan origination is the ordinary everyday activity of a bank and that the regularity of the expenses somewhat limits the potential for distortion, it is equally true that manufacturing and selling cars, the cost of which must be capitalized, is the ordinary everyday activity of General Motors. Likewise, while the Third Circuit may be correct that the credit check and other information gathered in the loan origination process has a life that lasts only until it is used, and thus the expenses to obtain that benefit might be said to have limited future benefit, the same might be said of the expenses incurred in a title search of real estate to be purchased, and those expenses clearly must be capitalized. Finally, looking through the prism of *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), would indicate that to focus on the life of the information obtained as result of the loan origination expenditures is myopic. That information, which itself might have had a short life, was a cost of producing the loans, just as the depreciation on the relatively short-lived construction equipment in Idaho Power was a cost of the long-lived power plant.

7. The Eighth Circuit uses symbolic [il]logic to divine the true meaning of *INDOPCO*, but allows a deduction to target for friendly takeover expenses. Wells Fargo & Co. v. Commissioner, 2000-2 U.S.T.C. ¶50,697, 86 A.F.T.R.2d 5815 (8th Cir. 8/29/00), *rev'g* Norwest Corp. v Commissioner, 112 T.C. 89 (3/8/99).

a. The **Tax Court** (Judge Laro) held that a takeover target's expenses for investment banking, legal and accounting fees for investigating whether to accede to the takeover were required to be capitalized because all these costs "were sufficiently related to an event that produced a significant long-term benefit," citing *INDOPCO*, *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648 (1992), and *A.E. Staley Manufacturing Co. v. Commissioner*, 105 T.C. 166 (1995), *rev'd and remanded*, 119 F.3d 482 (7th Cir. 1997).

- Even though these costs were not incurred as "direct costs of facilitating the event that produced the long-term benefit" – which would have been required by the 7th Circuit's Staley holding – "the costs were essential to the achievement of that benefit."
- Included among the costs capitalized was a $150,000 allocation from the salaries paid to 9 executives and 73 other officers of the target, attributable to their services on various aspects of the takeover transaction. The taxpayer argued that the salaries were deductible because they would have been incurred anyway and, alternatively, that the "business expansion" doctrine was implicitly codified by the enactment of §195. Taxpayer argued that the salaries were deductible under that doctrine (an argument that was a tough row to hoe because taxpayer had conceded that under INDOPCO the direct costs were capital expenditures). Expanding the holding in *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998), Judge Laro flatly stated that *INDOPCO* had effectively overruled the line of cases, starting with *Briarcliff Candy Corp v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), that allowed a current deduction for "business expansion" costs, in contrast to start-up costs. Judge Laro added that the enactment of §195 did not implicitly endorse the deductibility of all business expansion costs.



LEGEND

A = physical capital ASSET created or enhanced; ~A = NO physical capital ASSET created or enhanced;

B = BENEFIT beyond the taxable year; ~B = NO Benefit beyond the taxable year;

R = the expense is directly RELATED to B; ~R = the expense is indirectly related to B;

C = CAPITALIZE; D = DEDUCT.

b. The **Court of Appeals for the Eighth Circuit** reversed, stating that the Tax Court had illogically read *INDOPCO*. The Court of Appeals (District Court Judge Hand sitting by designation), analyzed the precedents and the facts using symbolic logic to conclude that *INDOPCO* did not require capitalization of expenditures that produced intangible long term benefits unless the expenditures were "directly" rather than "indirectly" related to the creation of the benefits. The court said:

> The Tax Court went on to hold: 'In accordance with *INDOPCO,* [all] the costs must be capitalized because they are connected to an event (namely, the transaction) that produced a significant long-term benefit." ... This is a misinterpretation of *INDOPCO*. ...
>
> [I]t was error for the Tax Court to require capitalization of the expenses at issue simply because they were incidentally connected with a future benefit. Instead, the Tax Court should have performed an independent and appropriate legal analysis to determine whether each of the expenditures at issue were "ordinary." ...

> The Tax Court erred when it so easily dismissed a major distinction between the instant case and *INDOPCO*. The *INDOPCO* case addressed costs which were directly related to the acquisition, while the instant case involves costs which were only indirectly related to the acquisition. ...
>
> [P]ayments made by an employer are deductible when they are made to employees, are compensatory in nature, and are directly related to the employment relationship (and only indirectly related to the capital transaction, which provides the long term benefit). Likewise, it is true that, a deductible expense is not converted into a capital expenditure solely because the expense is incurred as part of the terms of a corporate reorganization. Rather, the important consideration in determining the nature of an expenditure for tax purposes is the origin and character of the claim for which the expenditure is incurred. ...
>
> In *INDOPCO*, the expenses in question were directly related to the transaction which produced the long term benefit. Accordingly, the expenses had to be capitalized. ... We conclude that if the expense is directly related to the capital transaction (and therefor, the long term benefit), then it should be capitalized. ... In this case, there is only an indirect relation between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit ...).

- As far as the legal fees were concerned, on appeal the Commissioner conceded, applying the reasoning of Rev. Rul. 99-23, 1999-20 I.R.B. 3, by analogy, that any fees incurred during the "investigatory" stage were deductible. "Without adopting all of the conclusions in Rev. Rul. 99-23," but thereafter referring to it, the court agreed with the Commissioner, however, that any legal fees incurred by the target corporation after the "final decision" had been made to go forward with the acquisition were subject to capitalization. On the facts, the court held that this decision was made on the date the parties entered into the "Agreement and Plan of Reorganization," but the court stated that this holding was based on the facts and circumstances of the case and was not intended to provide a "bright line rule for determining when a 'final decision' has been made." It was small victory for the Commissioner. Only $27,820 of the target corporation's legal expenses were capitalized; the remaining $83,450, which were incurred prior to the "final decision" were deductible.
- Under the Court of Appeals analysis, an expense (1) that is recurring, i.e., ordinary, (2) that neither directly not indirectly creates a separate and distinct asset and (3) that is only "incidentally" [indirectly] related to producing a future benefit is not a capital expense
- Rev. Rul. 73–580, 1973–2 C.B. 86, which was not discussed or cited by the Wells Fargo court, requires that the salary of corporate employees who spend a "substantial" amount of time on acquisition work, e.g., legal accounting and other such activities in connection with acquisitions be capitalized. Nor did the Eighth Circuit cite or discuss *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), in which the Supreme Court held that an electric utility company that owned trucks and other equipment used in part for ordinary maintenance and in part to construct a power plant had to capitalize into the basis of the power plant the portion of depreciation allocable to the use of the equipment in the construction. In reaching its decision, the Court, in part, reasoned:

> There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) of the 1954 Code, 26 U.S.C. § 162(a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired. ...
>
> An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost; of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain

a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including depreciation charged to it by the contractor.

- In ignoring Idaho Power, the Eighth Circuit in *Wells Fargo* is either wrong or has created [whether or not is was trying to do so] a distinction in the treatment of indirect costs of assets and indirect costs of long-term benefits. There is also some indication that the Court of Appeals confused the Tax Court's terminology in Norwest (which referred to the expenses as "incidental" in the sense of indirect) and the Supreme Court's acknowledgment that "incidental" long term benefit does not require capitalization. The adjective is the same but the noun is different.

- The Commissioner's concession, applying the reasoning of Rev. Rul. 99-23, by analogy, that any legal fees incurred during the "investigatory" stage were deductible appears to be a concession that *INDOPCO* did not sub silentio completely overrule the business expansion doctrine as expounded in the *Briarcliff Candy* line of cases.

8. **Antitrust suit legal fees had to be capitalized.** American Stores Co. v. Commissioner, 114 T.C. No. 27 (5/26/00). Legal fees incurred in defending against State of California's federal antitrust suit challenging taxpayer's proposed acquisition of Lucky Stores were required to be capitalized under *INDOPCO* because they were paid in connection with an acquisition. The Federal Trade Commission had approved the acquisition under Hart-Scott-Rodino [15 U.S.C. §18a] in 1998 and Lucky Stores was acquired by taxpayer in that year, i.e., title was acquired but Lucky Stores continued to be separately operated; the California Attorney General continued to litigate until the matter was settled in 1990. Judge Ruwe held that the "principal difference between a deduction and an item that must be capitalized and amortized is the timing of the recovery of the expenditure," and that the long-term benefits of the acquisition were not available until 1990 when the Lucky's stores acquired could be integrated into taxpayer's existing operations.

9. **Keeping them happy down on the farm.** T.D. 8897, Rules for Property Produced in a Farming Business, 2000-36 I.R.B. 234 (9/5/00). Final regulations providing special rules for applying [limiting the application of] §263A to farming.

C. Reasonable Compensation

1. **The Seventh Circuit joins the Second Circuit in finding that the "independent investor" test should have been applied. Throw out all the reasonable comp factors. Judge Posner tells us there's a single inquiry that answers the question in every case. Judge Posner held that the Tax Court's use of a "multi-factor" test was improper.** Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 99-2 U.S.T.C. ¶50,964, 84 A.F.T.R.2d 6977 (7th Cir. 11/16/99), *rev'g* T.C. Memo. 1998-220 (Gerber, J.). Going a step further than the Second Circuit in *Dexsil Corp.*, a step that appears to be in the opposite direction in some ways than *Leonard Pipeline Contractors, Ltd.*, Judge Posner, writing for the Court of Appeals for the Seventh Circuit, castigated the Tax Court for its reliance on "factors" in resolving "reasonable compensation" cases and held that the only relevant inquiry is whether a hypothetical investor would be satisfied with the return on the investment that resulted form the employee/shareholder's management activities. According to Judge Posner, if the hypothetical investor would have been satisfied with the return, then the compensation, whatever it might have been, is reasonable. Judge Posner concluded that this limited test was sufficient to implement what he perceived to be the sole purpose of §162(a)(2), to prevent the distribution of dividends (or gifts) in the guise of deductible compensation.

- Thus, the Tax Court was reversed and a salary of $1,300,000 and $1,000,000 in successive years was held to be reasonable on the sole grounds that the IRS expert testified that a hypothetical investor would be satisfied with a 13 percent return and the corporation's return on invested capital was 20 percent. Judge Posner's opinion infers that, if the rate of return on invested capital is sufficiently above the "market" rate of return (adjusted for risk) and is due to the exertions of the employee/shareholder, there is no limit on the amount payable and deductible as compensation.It does not clearly explain why a hypothetical investor would be happy to see an unrelated manager appropriate the lion's the share of economic rents earned by a firm even though his test appears to allow the lion's share of economic rents to be distributed as deductible compensation as long a sufficient portion of the excess profits are retained or paid out as dividends to result in an above-market rate of return to invested capital. This problem may be partially addressed by the court's acknowledgment that for the payment to be deductible it must have been intended as compensation, rather than a dividend [as held in *O.S.C. & Associates, Inc. v. Commissioner*, 187 F.3d 1116, 99-2 U.S.T.C. ¶50.765, 84 A.F.T.R.2d 5735 (9th Cir. 11/6/99), which was not cited by Judge Posner], a requirement that Judge Posner found to have been satisfied in the instant case through the approval by other shareholders of the salary in question.

- Judge Posner was not content to set forth a test for the Tax Court to apply on remand. He reversed the judgment "with directions to enter judgment for the taxpayer."

2. But multi-factor reasonable compensation tests are alive and well out on the Coast, i.e., in the Ninth Circuit. LabelGraphics, Inc. v. Commissioner, 221 F.3d 1091, 2000-2 U.S.T.C. ¶50, 648, 86 A.F.T.R.2d 554 (9th Cir. 8/8/00), *aff'g* T.C. Memo. 1998-343. The Ninth Circuit (Judge McKeown) affirmed the Tax Court's decision that only $406,000 out of $878,913 paid as compensation to the sole shareholder of a corporation in which he was the "heart of the company" was deductible as reasonable compensation. In doing so, the Court of Appeals found that the Tax Court had correctly applied all of the "five broad factors" set forth in *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983).

> In *Elliotts*, we set out five broad factors that are relevant to the reasonableness inquiry: (1) the employee's role in the company; (2) a comparison of the employee's salary with those paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) evidence of an internal inconsistency in a company's treatment of payments to employees. *** No single factor is decisive. *** When conducting the reasonableness inquiry, "it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated."

3. Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo 2000-102 (3/27/00). In determining whether a hypothetical investor would be satisfied with the corporation's return to capital, it is misleading to compute a return based on the shareholder / employee's nominal initial contribution to capital [$119 in this case].

D. Miscellaneous Expenses

1. Notice of Proposed Rulemaking, Qualified Transportation Fringe Benefits, REG-113572-99, 2000-7 I.R.B. 624 (1/27/00). Prop. Reg. §1.132-9 provide in Q&A format extraordinarily detailed rules regarding scope of excludable qualified transportation fringe benefits under §132(f), including rules regarding elections under §132(f)(4) between taxable cash and tax-free qualified parking outside of the cafeteria plan rules.

2. *The deduction was more than the includible compensation – And it was legal! Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. No. 14 (3/28/00). Pursuant to Reg. §1.162-25T, an employer-corporation that provided private nonbusiness flights on a company owned airplane to employees was permitted to deduct the cost of providing the flights because the fair market value of the flights was included in the employees' reported compensation under Reg. §1.61-21(b). Accordingly, pursuant to § 274(e)(2), the limitations of § 274 did not apply even though the airplane otherwise could be considered to be an entertainment facility. Furthermore the employer's deduction was not limited to the lesser amount includable by the employees under special fringe benefit valuation rules [Reg. § 1.61-21(g)].

3. Aleda v. Commissioner, T.C. Memo 2000-136 (4/12/00). If the taxpayer has no regular place of business in the metropolitan area in which the taxpayer resides, even transportation expenses to travel to temporary job sites in other metropolitan areas are nondeductible commuting costs.

4. Jorgensen v. Commissioner, T.C. Memo 2000-138 (4/13/00). A public high school English teacher, who taught in a predominantly Asian-American school, incurred expenses to enroll in and attend University of California Extension courses in Southeast Asia religious traditions and Greek legends that were offered in Southeast Asia and Greece, respectively. The courses of study included lectures, assigned readings, and visits to historical sights. Although credit was available for the courses if the students wrote a topical paper, the taxpayer did not do so and did not seek credit. The expenses of course enrollment and travel were deductible educational expenses under Treas. Reg. §1.162-5 and were not disallowed under §274(m)(2).

5. Home is where the hearth is, well, where the AC is, since home was in Florida. Johnson v. Commissioner, 115 T.C. No. 16 (9/15/00). The taxpayer was the captain of a merchant ship that sailed worldwide carrying equipment of the U.S. military. He received lodging and meals while on-board the vessel, but paid for his other incidental travel expenses. Based on predecessors of Rev. Proc. 2000-9, 2000-2 I.R.B. 280, which provides that in lieu of substantiating actual travel expenses an employee may use the Federal per diem rates for meal and incidental expense (M & IE) to deduct meal and incidental expenses incurred while away from home, the taxpayer claimed miscellaneous itemized deductions based on the full M & IE rates. (He had no receipts.) The Tax Court (Judge Laro) rejected that Commissioner's argument that Johnson was an itinerant with no tax home from which to be away, and held that his permanent residence, where he resided with his wife and their daughter was his tax home. He had a legitimate reason for maintaining his personal residence while traveling throughout the world in the course of employment. That the employer provided meals and lodging excludable under §119 does not this result. The court stated:

> According to respondent, an employee such as petitioner can never have a tax home because he continually travels to different cities during his employment. We disagree that such continual travel, in and of itself, serves to disqualify a taxpayer from having a tax home for purposes of section 162(a). Regardless of where a taxpayer performs most of his or her work, the fact that he or she maintains financially a fixed personal residence generally means that he or she has a tax home someplace.

- Although the taxpayer's testimony, by itself, supported a finding that he paid incidental travel expenses while away from his tax home, he was denied the use of the full M & IE rates. The deduction was limited is limited to the amounts attributable to incidental expense, which was only $2 per day in the continental US and between $1 and $53 per day in other locations.

6. Only half the cost of Mint Juleps & country ham with beaten biscuits is deductible. Churchill Downs v. Commissioner, 115 T.C. No. 20 (9/26/00). The Tax Court (Judge Laro) held that §274(n) limited to 50% of the cost Churchill Downs' deduction for the expenses of entertainment [the Kentucky Derby sport of Kings Gala, press receptions, hospitality tents, winners parties, etc.] in connection with the Kentucky Derby, the Breeders' Cup, and other major horse races. Although Churchill Downs was in the "entertainment business" the expenses for the functions were not part of its entertainment product, which was horse racing. Nor were the costs deductible as entertainment available to the public [§274(n)(2), (e)(7) exception] or sold to customers [§274(n)(2), (e)(8) exception] because the functions were by invitation only and not open to the public.

E. Depreciation & Amortization

1. T.D. 8865, final regulations §1.167(a)-14 [dealing with depreciation of intangibles not subject to §197] and §1.197-2 [dealing with rules for amortization under §197] (65 F.R. 3820, 1/3/00). Regulations apply to property acquired after 1/25/00. Some highlights:

- For purposes of §197 a group of assets constitutes a trade or business if (1) their use would constitute a trade or business under §1060 [if goodwill or going concern value could, under any circumstances, attach to the assets], or (2) they include any franchise, trademark, or trade name [unlike the proposed regulations which applied this per se rule to any customer based intangibles].
- Purchased computer software is amortizable over 15 years if §197 applies but over 36 months if the software is not a §197 intangible. Section 197 (rather than Reg. §1.162-11) applies to costs to acquire a §197 intangible that is a limited interest in software. Computer software costs bundled in the cost of the computer hardware are capitalized and depreciated as part of the computer hardware.
- Amortization begins no earlier than the first day of the month in which the active trade or business or the activity described in §212 begins.
- A partnership generally may make curative or remedial allocations to its noncontributing partners of amortization relating to an asset that was amortizable (or a zero-basis intangible that otherwise would have been amortizable) in the hands of the contributor.
- A §743(b) basis step up in §197 intangibles generally may be amortized.
- If a right to use a §197 intangible is obtained under a license entered into as part of a purchase of a trade or business, amounts paid for the right are chargeable to capital account. An exception [not in the proposed regulations] applies to licenses of technology, know-how, and other similar

items (including most types of information base). Royalty payments under a contract for the use of §197 intangibles unconnected with the purchase of a trade or business are not required to be capitalized.

F. Credits

1. **Taxpayer must reduce basis in depreciable ITC transition period property by the full amount of the ITC initially available, not by the post-haircut ITC received during the transition period.** Telecom*USA Inc. v. United States, 192 F.3d 1068, 99-2 U.S.T.C. ¶50,916 (D.C. Cir. 10/15/99). Taxpayer must reduce its basis in depreciable property by the full amount of investment tax credit available to it in the year the property was placed in service, not by the reduced amount of ITC it received during the transition period following the 1986 ITC repeal. The court deferred to the IRS interpretation in Rev. Rul. 87-113, Example 3, because it is "an official interpretation by the Service," and noted that the government would prevail under even a minimal level of deference.

2. ***UK ACT paid by Compaq was a creditable income tax under §901.** Compaq Computer Corp. v. Commissioner, 113 T.C. 363 (11/18/99). Taxpayer was entitled to foreign tax credits for the advance corporation tax paid to the U.K. by a U.K. subsidiary on a dividend paid to taxpayer.

3. The **Tax Relief Extension Act of 1999** extended the increased investment expenditures credit through June 30, 2004. The 1999 Act also extended the credit to expenditures incurred in Puerto Rico and United States possessions (subject to limitations in §280C(c)(1) disallowing expenditures taken into account in determining the §41 credit from being taken into account in computing certain other credits).

- Special rules in §41(d) limit (1) the availability of the credit generated by activities incurred between July 1, 1999 and September 30, 2000 to offset tax payments due before October 1, 2000, and (2) the availability of the credit generated by activities incurred between October 1, 2000 and September 30, 2001 to offset tax payments due before October 1, 2001. This limitation pushes the credits into the following federal fiscal year to defer their impact on the surplus.

4. The **Tax Relief Extension Act of 1999** extended the §45 "electricity produced from renewable resources" credit to any facility *originally* placed in service by the taxpayer before 1/1/02. The credit also has been extended to electricity produced from poultry waste [the CS subcredit?] at a facility originally placed in service after 12/31/99 and before 1/1/02.

5. **"World headquarters" requires international operations.** Payless Cashways Inc. v. Commissioner, 114 T.C. No. 3 (2/16/00). ITC denied under the TRA 1986 §204(a)(7) rifleshot provision for the costs of equipping and furnishing a corporation's "world headquarters" because taxpayer lacked substantial international operations. Judge Ruwe held that this necessitated having either employees stationed outside the United States or exports or foreign source income or liability for foreign taxes or a foreign permanent establishment or foreign subsidiaries or foreign joint ventures.

G. Natural Resources Deductions & Credits

1. **Gathering pipelines depreciable over seven years.** True v. United States, 97-2 U.S.T.C. ¶50,946 (D. Wyo. 11/3/97). Summary judgment granted to taxpayer, a shareholder and partner in various gathering and trunk pipeline companies, permitting 7-year MACRS depreciation on its "gathering pipelines." Judge Johnson held that the gathering pipelines were used by petroleum producers to produce oil [Class 13.2 asset life] because these pipelines are necessary to provide "a means for producers to get crude oil from the lease to the collecting point for further transportation."

a. **Gathering pipelines depreciable over fifteen years. Is the moral to litigate in the District of Wyoming, and not in the Tax Court?** Duke Energy Natural Gas Corp. v. Commissioner, 109 T.C. 416 (12/16/97). Natural gas gathering systems are used to transport gas [Class 46.0] and is depreciable over 15 years. Judge Laro agreed with True, supra, that the classification of assets for depreciation purposes rests on each asset's primary use, but did not agree that pipeline companies use gathering lines primarily to produce petroleum.

b. ***Duke Energy reversed by the Tenth Circuit; seven years for gathering pipelines! Moral is to litigate in the Tenth Circuit.** Duke Energy Natural Gas Corp. v. Commissioner, 172 F.3d 1255, 99-1 U.S.T.C. ¶50,449 (10th Cir. 4/13/99). Held, gathering pipelines are in (production) Asset Class 13.2 [seven-year depreciation] because the primary use of gathering systems is more closely tied to production wells than are transmission pipelines. While gathering lines may, in a broad sense, "transport" or "carry" gas from one place to another within the literal terms of Asset Class 46.0, "we cannot ignore their more specific inclusion as assets used in the exploration for and production of gas in Asset Class 13.2." This applies even though taxpayer is not a "producer" of gas because there is no requirement that the pipeline user "own" the gas in the gathering pipelines.

c. ***The Commissioner will continue to litigate this issue outside the Tenth Circuit.** A.O.D. 1999-17 (11/22/99). The IRS will follow the Court of Appeals decision in Duke Energy in cases appealable to the Tenth Circuit if the opinion cannot be meaningfully distinguished. The IRS will not acquiesce in Tenth Circuit's decision and will continue to litigate the issue in cases appealable to courts of appeal in other circuits. Nonacquiescence published 1999-47 I.R.B.

2. S/V Drilling Partners v. Commissioner, 114 T.C. No. 4 (2/21/00) (reviewed, 13-2). Partnership produced and sold 15,483 barrel equivalents of gas from a tight formation and 16,927 barrel equivalents from a tight formation that was also Devonian shale. Partnership claimed a §29 credit not indexed for inflation for the 15,483 barrel equivalents from the tight formation and a double credit ($3 + $3 indexed for inflation) for each barrel equivalent produced from the tight formation that was also Devonian shale. In a reviewed opinion by Judge Colvin (with two differing dissents), the Tax Court held that §29 does not provide a double credit for gas produced from a tight formation that is Devonian shale. Only one credit, based on production form Devonian shale, which is indexed for inflation, is allowed. But the court rejected the Commissioner's argument that taxpayer's credit was limited to the greater of (1) $3 unindexed on the full 32,410 barrel equivalents from a tight formation or (2) $3 indexed on the 16,927 barrel equivalents from Devonian shale.

- Judge Foley dissented on the double credit issue and Judge Vasquez dissented on the indexing issue.

3. Fixed contract natural gas percentage depletion (on remand). Exxon Corp. v. United States, 2000-1 U.S.T.C. ¶50,116, 84 A.F.T.R.2d 7235 (Fed. Cl. 12/2/99). Exxon sought a $172.6 million refund based on percentage depletion for 1975, under §613A(b)(1)(B), allowing §613 percentage depletion for natural gas sold under a fixed contract. The long-term contracts in issue were with Houston Lighting & Power Co. (HL&P) and with Southwestern Electric and Power Co. (SWEPCO). The IRS assessed a deficiency for 1975 on the grounds that Exxon was not entitled to use the RMFP under Reg. §1.613- 3(a) to compute percentage depletion because the fixed-contract exception in §613A(b)(1)(B) did not permit use of the RMFP. Exxon filed suit, and the Court of Claims initially denied the government's motion for summary judgment, in which the government argued that Reg. §1.613-3(a) did not apply to post-1974 depletion allowed under the fixed contract exception.

- On the government's motion for summary judgment, the court (Senior Judge Gibson) held that: (1) Reg. §1.613-3(a) absent evidence that the regulation systematically causes a material distortion of the "gross income from the property" it was not facially invalid as applied to percentage depletion deduction pursuant to post-1974 fixed contract exception [even if the RMFP exceeded the actual sales price, which it can under Exxon, Corp. v. United States, 88 F.3d 968, 96-2 U.S.T.C. ¶50,324 (Fed. Cir. 1996)], and (2) evidence raised genuine issues of material fact the regulation produced a result that was arbitrary, capricious, or manifestly contrary to post-1974 statutory percentage depletion scheme. 40 Fed. Cl. 73, 98-1 U.S.T.C. ¶50,142 (1998).

After trial, the court held:

- First: Not all of the natural gas was eligible under Reg. §1.613A-7(c)(5) and (d). Exxon failed to prove that its contract with HL&P qualified as a "fixed contract." The HL&P excess royalty reimbursement and additional gas contract terms permitted Exxon, in part, to raise prices after Feb. 1, 1975 by amounts tied to the market price for natural gas. [which would allow it to recover through price increases increased tax liabilities arising from the repeal of percentage depletion], and the sales prices did in fact increase. Exxon did not prove by "clear and convincing evidence" that the price increase did not "to any extent" permit it to recoup tax increases attributable to the repeal of percentage depletion. The contract with SWEPCO, however, was qualified. Although the contract had a price adjustment clause under which Exxon "could potentially have recovered a portion of its increased income tax liabilities," the contract qualified as a "fixed contract" because the contract price did not in fact increase after February 1, 1975.

- Second: For calculating Exxon's 1975 percentage depletion allowance, the RMFP is $0.6831 per thousand cubic feet (Mcf) of natural gas that is eligible for percentage depletion. (1) The Texas Gulf Coast/East Texas region, rather than the entire state, constituted a "market area that was geographically 'representative'" of Exxon's 1975 production from the properties at issue. (2) In determining whether that region was the relevant market area, Judge Gibson found that Exxon's 1975 "gas well gas production" B comprising 90.24 percent of the gas in issue B was comparable or superior to gas produced and sold generally through the region; only 9.74 percent [casing head gas]was not comparable and must be excluded from the computation of Exxon's allowance. (3) After determining the appropriate RMFP transaction sample and adjusting for the pre-sale costs of compression and dehydration, the court held that the RMFP for purposes of Reg. §1.613-3(a) was $0.6831 per Mcf.
- Exxon had argued that every sale of raw gas at a delivery point anywhere on the producer's lease property was a transaction in which the sale price was untainted by transportation before the sale. The court held that Exxon failed to support that position, and that it was not feasible to cure tainted transactions by subtracting the transportation cost from the gas sale price.

a. **Tax Court: Taxpayer not permitted to follow the literal language of the regulations.** Exxon Corp. v. Commissioner, 102 T.C. 721 (6/6/94). Taxpayer was not permitted to follow the literal language of Reg. §1.613-3(a) and use "representative market or field prices" (RMFP) in determining "gross income from the property" for purposes of computing percentage depletion under §613A(b)(1)(B) ["fixed contract" exception]. Even though the regulation states that "the gross income from the property shall be assumed to be equivalent to RMFP" with respect to natural gas transported from the premises prior to sale, the purpose of that provision was to prevent integrated producers from taking depletion deductions on transportation, refining, etc. -- and not to permit taxpayer to take depletion based upon a RMFP price five times the actual sales price of the natural gas to an Exxon affiliate. The actual contract sales price was therefore reduced by royalties and transportation expenses to determine "gross income from the property."

b. **Same issue in Court of Federal Claims.** Exxon Corp. v. United States, 33 Fed. Cl. 250, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 4/11/95). On the same issue, the Court of Federal Claims held, that while the amount upon which depletion can be taken is not necessarily limited by actual gross income [21 cents], the RMFP calculated by Exxon [41 cents] was not a reasonable basis upon which depletion may be taken and [based upon the burden of proof] the complaint was dismissed. **But reversed:**

c. **Federal Circuit holds that RMFP which exceeds actual gross receipts is not precluded, nor is it per se "unreasonable."** Exxon Corp. v. United States, 88 F.3d 968, 96-2 U.S.T.C. ¶50,324 (Fed. Cir. 6/20/96), *cert. denied* (3/17/97), *rev'g and remanding* 33 Fed. Cl. 250, 95-1 U.S.T.C. ¶50,245 (Fed. Cl. 1995). Court finds taxpayer entitled to calculate its depletion deduction based upon an RMFP of 39 cents based upon the wellhead price that would be realized by nonintegrated producers. The court further held that the Court of Federal Claims should not have limited the price by making an independent assessment of the reasonableness of the price because the §611(a) language "reasonable allowance ... in each case" refers to the different types of depletable resource, not to individual taxpayers.

4. ***UK PRT paid by Exxon was a creditable income tax under §901.** Exxon Corp. v. United States, 113 T.C. 333 (11/2/99). Taxpayer is entitled to foreign tax credits for petroleum revenue tax paid to the U.K. Judge Swift held that the taxes were "excess profits or income tax in the U.S. sense," and were not paid for "specific economic benefits Exxon received under its North Sea licenses."

- Exxon claimed foreign tax credits for hundreds of millions of U.K. pounds of petroleum revenue taxes (PRT) paid to the United Kingdom in the years 1983-88. The IRS disallowed the credits, arguing that a tax on gross income was not a U.S.-style net income tax. Under Reg. §1.901-2(b)(4)(i), a foreign tax satisfies the net income requirement for qualification as an income tax in the U.S. sense if the tax base permits "recovery of the significant costs and expenses" relating to producing the income, or provides "recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses."

- The Tax Court (Judge Swift) held that PRT paid by Exxon to the United Kingdom for 1983 through 1988 was a creditable income tax under §901. The PRT, enacted at the same time as the Ring Fence Tax [a modified version of the corporate income tax that applies only to companies producing oil and gas and conducting related activities in the North Sea] is administered by the U.K. Inland Revenue. Unlike royalties, PRT must be paid in cash. The PRT tax base is gross income from North Sea oil and gas activities; losses from activity outside the North Sea ring are not allowed as an offset. North Sea activities are generally not subject to PRT until they show a cumulative profit. Current deductions are not allowed for interest expense and other items, but deductions are allowed for "uplift" (35 percent of most related capital expenditures). For 1975-88, Exxon was allowed uplift totaling 1.8 billion U.K. pounds, about twice the total nonrecoverable interest expense. The IRS argued that the "uplift" allowance represented "too 'crude' a substitution for a deduction for interest expense, that PRT fails to provide an allowance that 'mimics' interest expense, and that the relationship of PRT allowances to nonrecoverable expenses is not sufficiently 'predictable.'" Exxon received no special benefits, such as exploration rights, in exchange for paying PRT; it paid substantial license and royalty fees in addition. The court held that the PRT met the net income test of Reg. §1.901-2(b)(4)(i) because credible expert testimony and industry data established that the uplift allowance effectively compensated the taxpayer for the disallowed expenses. That the UK might have charged more in license fees before enacting the PRT does not affect its character. The predominant character of the PRT was in the nature of an excess profits tax.

5. **Delay rentals meet the uniform capitalization rules.** REG-103882-99, Notice of Proposed Rulemaking, Depletion; Treatment of Delay Rentals (65 F.R.6090, 2/8/00). The Service has released Prop. Reg. §1.612-3(c)(2), which would conform the regulations on delay rentals to the requirements of §263A. Current Reg. §1.612-3(c)(2) allows a payer to elect to deduct a delay rental as an expense or charge it to depletable capital account under §266. In contrast, §263A, which was enacted after Current Reg. §1.612-3(c)(2) was finalized, requires a delay rental to be capitalized in some circumstances. [The uniform capitalization rules of §263A generally require the capitalization of all direct costs and certain indirect costs properly allocable to property produced by the taxpayer.] The proposed regulations would provide that the payer of a delay rental may elect to currently expense the delay rental or charge it to depletable capital account under §266 to the extent that §263A does not require capitalization. Capitalization may be required even though production (development) has not yet begun. Reg. §1.263A-2(a)(3)(ii).

a. Industry Specialization Paper for the Petroleum Industry (9/19/97). The Service concluded that delay rentals under oil and gas leases held for development, that are incurred in tax years beginning after 12/31/93, are required to be capitalized and added to the depletable basis of the property to which they relate.

b. TAM 9602002 (9/19/95). Delay rentals paid by the taxpayer are pre-production costs subject to capitalization under §263A as costs of producing oil and gas property.

6. **Renegotiated advance minimum royalties are not "uniform."** Reliant Energy, Inc. v. United States, 45 Fed. Cl. 302, 99-2 U.S.T.C. ¶51,000, 84 A.F.T.R.2d 7059 (Fed. Cl. 11/24/99). Advance minimum royalties of $500,000, paid under a lease that originally called for advance minimum royalties of $2,000,000 per year that, as a result of a decline in the market for lignite, were renegotiated to $500,000 per year for five years, then returning to $2,000,000, were not currently deductible. The advance minimum royalties were not "substantially uniform for a period of 20 years or the life of the lease," as required by Reg. §1.612-3(b)(3). Rev. Rul. 81-299, 1981-2 C.B. 138, treating advance minimum royalties adjusted for inflation by the CPI as substantially uniform, was distinguished on the grounds that the amount of the changes of the amount of the royalty in the Ruling were beyond the control of the parties. In this case, the event that led to the renegotiation might have been beyond the parties' control, but the change was not.

7. Notice 2000-50, 2000-38 I.R.B. 291 (9/18/00). Percentage depletion [15%] remains available to independent producers and royalty owners under §613A(c). Section 613A(c)(6) increases the percentage depletion rate on oil or gas that is "marginal production," by one percentage point, to a maximum rate of 25 percent, for each dollar by which the "reference price" for crude oil – generally speaking, average wellhead price per barrel for domestic crude oil B for the preceding calendar year falls below $20. The applicable percentage for purposes of determining percentage depletion for oil and gas produced from marginal properties 2000 is 19 percent [down from 24 percent for 1999].

8. Notice 2000-51, 2000-38 I.R.B. 291 (9/18/00). The §43 credit for domestic "enhanced oil recovery costs" equals to 15 percent of qualified costs for the taxable year. The credit is subject to phase-out for any taxable year in which the reference price of crude oil (determined under §29(d)(2)(C)) for the prior year exceeds $28 (adjusted for inflation); the credit is wholly phased out if the reference price of oil equals or exceeds $34, adjusted for inflation. The enhanced oil recovery credit for taxable years beginning in 2000 is determined without reference to the phase-out.

H. Loss Transactions, Bad Debts and NOLs

1. **Behold the mighty powers of the Bankruptcy Trustee. He avoids irrevocable elections in a single bound.** United States v. Sims (In re Feiler), 2000-2 U.S.T.C. ¶50,579, 86 A.F.T.R.2d 5001 (9th Cir. 6/27/00), *aff'g* 230 B.R. 164 (9th Cir. BAP. 1999). A prepetition election to waive a net operating loss carryback – allegedly "irrevocable" under §172 – may nevertheless be avoided by the bankruptcy trustee as a fraudulent transfer pursuant to 11 U.S.C. §548(a)(2). Under §1398, the bankruptcy estate succeeds to tax attributes of the debtor, including the "net operating loss carryovers determined under section 172." Follows *In re Russell*, 927 F.2d 413, 91-1 U.S.T.C. ¶50,128 (8th Cir. 1991).

- Although the election to waive an NOL carryback under §172(b)(3)(C) is irrevocable, if it was made within one year prior to the taxpayer's bankruptcy, it may be avoided by trustee in bankruptcy under §548(a)(2) of the Bankruptcy Act as a voidable transfer of property for less than full consideration. The tax refund the NOL carryback could have produced is property and the United States is a transferee by virtue of not having paid the refund that otherwise would have been paid and available to creditors. Section 1398(g)(1), providing that the bankruptcy estate succeeds to the debtor-taxpayer's NOLs does not displace §548(a)(2) of the Bankruptcy Act.

2. Culley v. United States, 221 F.3d 1331, 2000-2 U.S.T.C. ¶50,662, 86 A.F.T.R.2d 5628 (Fed. Cir. 8/15/00). The taxpayer orchestrated a bribery and kickback scheme under which his corporation overcharged customers for products. Subsequently he sold the business for a price that was based in part on the artificially inflated earnings. When the scheme fell apart, as part of a combined settlement of the criminal charges and civil suits, the taxpayer agreed to make restitution to the customers and the purchaser of the business. He was allowed a §165 loss deduction, but not the benefits of §1341. Section 1341 applies only if it appeared to the taxpayer himself at the time of receipt that he had an unrestricted right to the funds subsequently repaid. Thus, a deduction for restitution of funds obtained by fraud is not subject to §1341, event though it may have appeared to the defrauded parties at the time that they paid him that the taxpayer had an unrestricted right to the funds.

I. At-Risk and Passive Activity Losses

1. Connor v. Commissioner, 218 F.3d 733, 2000-2 U.S.T.C. ¶50,560, 86 A.F.T.R.2d 5201 (7th Cir. 7/5/00). The Seventh Circuit upheld the Commissioner's interpretation of the 1992 versions of Prop. Reg. §§1.469-4(a), -4(c)(2) and -2(f)(6) (1992) to recharacterize as nonpassive income rental income received from a C corporation in which the taxpayer's materially participated. [This result is clearly mandated by the final Regs., see *Fransen v. United States*, 191 F.3d 599 (5th Cir. 1999).] The "written binding contract" exception in Treas. Reg. §1.469-11(c)(1)(ii) did not apply on the facts because the lease was unenforceable under state law.

2. Kosonen v. Commissioner, T.C. Memo 2000-107 (3/28/00). The aggregation of losses from seven rental real estate properties on Schedule E [as active losses under §469(c)(7)] did not constitute an election to treat the activities, which were recharacterized by the IRS and Tax Court as passive activities because the taxpayer did not materially participate, as a single activity. An election must clearly notify the IRS that the election is being made. That the IRS had not yet published guidance regarding how to make the election did not affect the decision.

3. ***The statute was self-executing; the taxpayer doesn't have to wait for Regs.** Hillman v. Commissioner, 114 T.C. No. 6 (2/29/00). The taxpayer's S corporation performed management services for real estate partnerships in which the taxpayer directly or indirectly was a partner. The taxpayer received passthrough nonpassive income from the S corporation and passthrough passive deductions from the partnerships. Based on §469(*l*)(2) and its legislative history, under circumstances analogous to those in Prop. Reg. §1.469-7. 56 F.R. 14034 (4/5/91) permitting the offsetting

of "self-charged" interest incurred in lending transactions, the taxpayer offset passive management fee deductions against the corresponding nonpassive management fee income. Section 469(*l*)(2) provides that the IRS "shall" promulgate regulations "which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)." Prop. Reg. §1.469-7 permits offsetting of "self-charged" interest incurred in lending transactions, but the IRS did not issue any regulation for self-charged items other than interest. Under the proposed regulations, a taxpayer who was both the payor and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive interest income. The Commissioner argued that the taxpayer could not set off the deductions and income because the IRS had not issued regulations for self-charged items other than interest and had thereby limited the offset. The court (Judge Gerber) held that the substantive set-off rule was self-executing and the taxpayer was entitled to offset the passive management deductions against the nonpassive management income. Such self-charged treatment was congressionally intended not only for interest, but also for other appropriate items, and the Commissioner did not argue that there was any distinction of substance between interest and management fees within the self-charged regime.

4. An S corporation and 116 partnerships are a single activity. Glick v. United States, 96 F. Supp. 2d 850, 2000-1 U.S.T.C. ¶50,372, 86 A.F.T.R.2d 5083 (S.D. Ind. 3/14/00). In 1992 and 1993, the taxpayer was a partner in 116 limited partnerships that owned rental real estate. In 79 of the partnerships, the taxpayer held a "controlling" general partnership interest and in 33 of them, the taxpayer held a 1 percent general partnership interest. The court agreed with the taxpayer that under Reg. §1.469-2(d) the partnerships could be aggregated with an S Corporation, in which the taxpayer owned 93.6% of the stock, and in which taxpayer materially participated, which permitted the taxpayer to claim the losses from the partnerships against nonpassive income. The S corporation was formed specifically for the purpose of managing the limited partnership's rental properties and did so. Thus the partnerships and the S corporation were "an "appropriate economic unit" under the regulations. The entities were "so substantially intertwined that to separate their income for tax purposes would unfairly deny them the benefits of section 469's limitations." In addition, the S corporation's trade or business activities, i.e., managing the real estate, were "insubstantial' relative to the partnership's rental activities because the S corporation's gross income was less than 11% of that of the partnerships and the fair market vale of the S corporation's assets was approximately 3% of that of the partnerships. That the S corporation's activities were "essential" to the partnerships did not as a matter of law render the S corporation's activities not relatively insubstantial. [Note that after 1993, §497(c)(7) might moot this issue for a taxpayer who in engaged in the real estate business.]

5. *Both a co-owner and borrower from your co-owner be ye not. Van Wyk v. Commissioner, 113 T.C. 440 (12/21/99). The taxpayer and another person each owned 50 percent of the stock of an S corporation engaged in the farming business. Taxpayer and his wife borrowed funds from the other shareholder and his wife and relent them to the corporation, after which taxpayer attempted to claim passed-through losses against the debt basis under §1366(d)(1)(B). The Tax Court (Judge Wells) held that pursuant to §465(b)(3), the taxpayer shareholder was not at risk for amounts lent to the corporation because he borrowed the funds from another shareholder (and that shareholder's spouse, from whom borrowing is treated in the same manner as borrowing from the husband under §465(b)(3)(c)) to relend them to the corporation. The taxpayer was thus denied a current deduction for losses passed through under §1366. Money that is borrowed from a third party by the taxpayer on his own credit and then invested or contributed by the taxpayer to an activity is not governed by §465(b)(1)(A), but rather is treated as borrowing with respect to the activity and will be considered to be at risk only if the borrowing transaction passes muster under the several other subsections of §465 dealing with the treatment of borrowed funds. The negligence penalty was not upheld because "the complexity of section 465 and the lack of express guidance in the regulations, led [taxpayers] to an honest mistake."

6. A double loss. More v. Commissioner, 115 T.C. No. 9 (8/15/00). The taxpayer was an individual Lloyds of London underwriter who pledged stock to secure a letter of credit posted to show he could cover claims. When he incurred losses on claims paid, the issuer of the letter of credit sold the stock. Because the stock had been acquired before underwriting activity began, the gain was portfolio income under §469(e)(1)(A) and Reg. §1.469-2T(c)(3)(i)(C) which could not be offset by the passive activity losses from the insurance claims. The stock was not property used in the trade or business of insurance underwriting and the gain was not derived in the ordinary course of business. The court noted however, that income generated in the ordinary course by the investment component of a reinsurance business is not portfolio income. Thus if the stock had been purchased with premiums for the insurance business and acquired and held for the purpose of "showing means" to cover potential losses, gain might have been passive.

III. CAPITAL GAIN AND LOSS

A. In general

1. **Accountants did not allocate any basis to a claim purchased along with other assets because it was "too speculative." Settlement of the claim resulted in ordinary income when there was no "property" transferred to the defendant in return for the payment.** Nahey v. Commissioner, 111 T.C. 256 (10/21/98). Taxpayer's S corporations purchased the assets of another corporation, which included a breach of contract and misrepresentation claim against Xerox for failing to complete the installation of a computer system. In allocating values to purchased assets, no value was assigned to the Xerox claim because the accountants determined it was "too speculative." Held, the settlement proceeds are ordinary income, not capital gain, citing Hudson v. Commissioner, 20 T.C. 734 (1953), to the effect that taxpayer's corporations did not transfer any property to Xerox, so the claim was extinguished (or paid), and not sold or exchanged. Judge Jacobs also distinguished Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), because in that case there were property rights [the right to produce the play Moulin Rouge] that reverted to the author, and in this case [Nahey] any property rights simply vanished.

a. ***Affirmed. The buyer of the lawsuit has ordinary income because the seller would have had ordinary income.** Nahey v. Commissioner, 196 F.3d 866, 99-2 U.S.T.C. ¶50,969, 84 A.F.T.R.2d 7008 (7th Cir. 11/17/99). The Court of Appeals affirmed the Tax Court, but on rather convoluted reasoning. Rather than focusing on the "sale or exchange" requirement, the Court of Appeals held that the settlement proceeds were ordinary income upon collection by Nahey – even if gain on a subsequent sale by him, as a purchaser, if one had occurred, might have been capital gain – because under the principles governing characterization of receipts of damages their receipt would have been ordinary income if they had been received by seller in the same manner. Inasmuch as the proceeds of the lawsuit would have been ordinary income to the seller, the purchasers [two S corporations] of the corporate assets (in a leveraged buyout) also have ordinary income on the settlement of the lawsuit. Judge Posner rejected taxpayer's argument that the lawsuit became a capital asset of the purchasing corporations.

2. ***A safe harbor for debt modifications; the debt substitute election is now permanent.** Rev. Proc. 2000-29, 2000-28 I.R.B. 113 (6/22/00). Eliminates the 6/30/2000 sunset date and makes the debt substitution election of Rev. Proc. 99-18 permanent. Under this election a taxpayer can treat a substitution of debt instruments as a realization event for federal income tax purposes even though there is no "significant modification" under Reg. §1.1001-3; the taxpayer would not recognize any realized gain or loss immediately, but would take gain or loss into account over the term of the new debt instrument.

- Applies to substitutions after March 1, 1999.

a. Rev. Proc. 99-18, 1999-11 I.R.B. 7 (3/1/99). Provides for an election to treat a substitution of publicly-traded debt instruments as a realization event for federal income tax purposes, even though it does not result in a significant modification under Reg. §1.1001-3 (and is, therefore, not an exchange). The election is made by a written agreement between the issuer and the holders of the debt instruments. Under this election, taxpayers do not recognize any realized gain or loss on the date of the substitution, but instead take the gain or loss into account over the term of the new debt instruments. Applicable to substitutions that occur between 3/1/99 and 6/30/00.

- Allows elective realization upon substitution of debt instruments if the modification or substitution does not constitute a significant modification under Reg. §1.1001-3. The issuer treats the new instrument as an OID instrument or an instrument with bond premium. The holder takes a substituted basis and treats new instrument as market discount bond if the redemption price exceeds the substituted basis.

3. **Restructured §1221. Exceptions listed in §1221(a)(1) through (8) are exclusive, so common-law exceptions no longer available. *Corn Products* exception codified in §1221(a)(7).** The

Tax Relief Extension Act of 1999 restructured §1221 to create a subsection (a) in which the categories of property that are not capital assets are listed and a subsection (b) providing certain definitions relating to the some of the categories of assets in §1221(a). The 1999 Act also added three additional categories of assets, listed in §1221(a)(6) - (8) that are excluded from the definition of "capital asset."

- New §1221(a)(6) excludes any "commodities derivative financial instrument" held by a commodities derivatives dealer, unless (1) it is established to the satisfaction of Commissioner that the particular instrument in question had no connection to the activities of the dealer as a dealer, and (2) the instrument was clearly identified in the dealer's records as having no connection to the dealer activities before the close of the day on which it was acquired, originated, or entered into.
- New §1221(a)(7) excludes any hedging transaction that has been clearly identified as such before the close of the day on which it was acquired, originated, or entered into. This provision in effect largely codifies previously promulgated regulations [Reg. §1.1221-2], but changes the definition of a hedging transaction somewhat from that provided in the regulations. Presumably the negative inference is that if a hedging transaction has not been so identified, it will be a capital asset.
- Finally, new §1221(a)(8) excludes supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer. This subsection is more closely related to §1221(a)(1) (as §1221(1) was renumbered in 1999), which excludes inventory, stock in trade, and property held primarily for sale to customers in the ordinary course of business, but which does not expressly exclude stocks of previously expensed supplies used in the course of providing services. This new provision eliminates any question in this regard, relegating supplies to ordinary asset characterization. This assures that hedging transactions with respect to such supplies, for example, jet fuel for an airline, would be ordinary transactions. In a number of cases, supplies consumed by the taxpayer or the taxpayer's customer in the course of providing services have been held not to be inventory for purposes of accounting method rules, and these cases raise the question of whether such supplies, which have been expensed upon purchase, are capital assets. Section 1221(a)(1) does not expressly exclude stocks of previously expensed supplies used in the course of providing services, and neither does §1221(a)(2).
- Section 1221(b)(1) defines a "commodities derivatives dealer" as any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business. A "commodities derivative financial instrument" is defined in §1221(b)(2) as any contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a fixed rate, price, or amount, or a variable rate, price, or amount, which is based on current, objectively determinable financial or economic information. This definition includes instruments such as swaps, caps, floors, options, futures contracts, forward contracts, and similar financial instruments with respect to commodities, but it does not include shares of stock in a corporation; a beneficial interest in a partnership or trust; a note, bond, debenture, or other evidence of indebtedness; or a contract to which §1256 applies.
- Section 1221(b)(2) codifies the definition of "a hedging transaction" in generally the same manner as Reg. §1.1221-2, but broadens the scope by abandoning the "risk reduction" standard of the regulations to one of "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer. In addition, §1221(b)(2)(A)(iii) permits the IRS to expand by regulations the definition to include transactions entered into primarily to manage other risks. Congress did not intend that the "risk management" based definition of a hedging transaction extend to "speculative transactions or other transactions not entered into in the normal course of a taxpayer's trade or business."
- Section 1221(b)(2)(B), requires the Treasury to issue regulations requiring proper characterization of (1) transactions that are in fact hedging transactions but which have not been properly identified and (2) transactions that have been identified by the taxpayer as hedging transactions but which in fact are not hedging transactions. Thus, the identification or non-identification of an asset as a hedging transaction presumably will only create a presumption one way or the other. Because the accompanying committee reports express congressional concern that taxpayers may seek to "whipsaw" the Treasury, the identification rule is highlighted as important. Thus, the recharacterization pursuant to regulations issued under §1221(b)(2)(B) very well may turn out be a sword only for the Treasury, with the taxpayer's identification (or non-identification) being only a partial shield.

4. New §1260. In 1999 Congress enacted new §1260 in response to its concerns with the use of derivative contracts – forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly -- by taxpayers in arrangements designed primarily to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain.

- Congress was particularly concerned with derivative contracts with respect to partnerships and other pass-thru entities that might have resulted in the taxpayer being taxed more favorably than if he actually had acquired an ownership interest in the entity. These transactions escaped the ambit of §1258, which only applies to transactions in which the taxpayer's expected return is attributable solely to the time value of his net investment.
- One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.
- Section 1260 presents a double-barreled attack on such transactions. First, §1260(a)(1) limits the amount of gain with respect to any "constructive ownership transaction with respect to any financial asset" that may be characterized as long term capital gain. The amount of gain that may be characterized as long-term capital gain is limited to the "net underlying long-term capital gain," essentially the amount of gain that would have been long-term capital gain if, during the term of the derivative contract, the taxpayer had held the underlying assets directly. Any gain in excess of this amount is ordinary income. Second, §1260(b) imposes an interest charge with respect to deferral effected during years the transaction remained open on any gain treated as ordinary income, as opposed to capital gain, under §1260(a)(1).

5. Capital gains rules on sales of interests in passthrough entities ade final, with some modifications. T.D. 8902, final regulations on capital gain on sale of passthrough entities (65 F.R. 57092, 9/21/00). The look-through provisions will not apply to the redemption of a partnership interest. The allocation of a divided holding period [where a partner acquired portions of an interest at different times]continues to be the rule, but exceptions are provided (1) to permit a partner to reduce cash contributions made during the year before the sale by cash distributions received during the same period on a LIFO basis, and (2) to permit the IRS to provide additional exceptions in published guidance for other cash contributions. The final regulations also provide that deemed contributions and distributions of cash under

a. Don't you just love dealing with the nuances of multiple capital gains rates? Notice of Proposed Rulemaking, Capital Gains, Partnership, Subchapter S, and Trust Provisions, REG-106527-98, 1999-34 I.R.B. 304 (64 F.R. 43117, 8/9/99). [Effective for transactions on or after the date the final regulations are published.]

(1) Prop. Reg. §1(h)-1, dealing with rates applicable to sales of interests in entities that own property subject to different capital gains rates under §1(h) for taxable years ending after May 6, 1997.

- Pursuant to §1(h)(6)(b), any gain from the sale of an interest in a partnership, an S corporation, or a trust that has been held for more than one year (or more than 18 months for relevant periods in 1997) that is attributable to unrealized appreciation in the value of collectibles held by the entity is treated as gain from the sale or exchange of a collectible [applying rules similar to §751(a) to determine the amount of that gain]. The amount of collectibles gain equals the collectibles gain that would be allocated to the selling partner, shareholder, or beneficiary [with respect to the portion of the transferred interest that is subject to long-term capital gain] if the entity had sold all of its collectibles in a taxable transaction immediately before the transfer of the interest. If the partner, S corporation shareholder, or trust beneficiary recognizes less than all of the gain upon the sale of its interest, a proportionate part of the gain is treated as collectibles gain.
- Under §1(h)(7)(A), the amount of long-term capital gain (not otherwise treated as ordinary income under §751(a)) that would be treated as if §1250 applied to all depreciation is unrecaptured §1250 [capital] gain, subject to a maximum rate of 25 percent. The proposed regulations follow H. Rep. No. 105-356, 105th Cong. 1st Sess. (1997), at 16, fn. 11; S. Rep. No. 105-174, 105th Cong. 2d Sess. (1998), at 149, fn. 65, and provide that upon the sale of a partnership interest held for more than one year, the amount of the gain that would have been ordinary income under §751(a) if the partnership's

unrecaptured §1250 gain had been ordinary income is treated as unrecaptured §1250 gain by the selling partner. The amount of the overall gain that is unrecaptured §1250 gain equals the amount that would have been the partner's share of unrecaptured §1250 gain if the partnership had sold all of its §1250 property in a taxable transaction immediately before the transfer of the partnership interest. If the partner recognizes less than all of the gain upon the sale of the interest, a proportionate part of the gain is treated as unrecaptured §1250 gain. However, for purposes of applying §1(h)(7)(B) [which limits unrecaptured §1250 gain to the taxpayer's net §1231 gain] a selling partner's gain from the sale of a partnership interest that results in §1250 capital gain is not treated as §1231 gain even if §1231 would apply to a disposition of the underlying partnership property. The Treasury believes that although §1(h)(7) requires a "look-thru rule" for determining the capital gain rate applicable to the sale of a partnership interest while no "lookthru rule" applies for applying §1231, "[a]nomalous results would follow if §1250 capital gain derived from the sale of a partnership interest were treated as §1231 gain for purposes of applying the limitation in §1(h)(7)(B) but not for purposes of actually applying §1231."

(2) Prop. Reg. §1.1223-3, dealing with holding period of a partnership interest acquired at different times in multiple transactions. Because a partner has a single basis in a partnership interest [Rev. Rul. 84-53, 1984-1 C.B. 159], even if the partner acquired portions of the interest at different times or acquired the interest in a single transaction that gave rise to different holding periods under §1223. partnership. If a partner sells the entire partnership interest, any capital gain or loss is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. The portion of a partnership interest to which a holding period relates is a percentage that equals the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates divided by the fair market value of the entire partnership interest (determined immediately after that transaction). A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a "publicly traded partnership" [see §7704(b)], the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Otherwise, the holding periods of the transferred interest must be divided in the same ratio as the holding periods of the partner's entire partnership interest. The preamble notes that IRS may apply judicial doctrines, e.g., substance over form or step transaction, or Reg. §1.701-2 to attack abusive transactions designed to shift gain from the portion of a partnership interest with a short-term holding period to the portion with a long-term holding period.

IV. CORPORATIONS

A. Entity and Formation

1. ***No more double-counting §357(c) gains in basis.** P.L. 106-36, the Miscellaneous Trade and Technical Corrections Act of 1999 amended §357(c) and added new §357(d) to limit basis increases attributable to assumption of liabilities not to exceed the fair market value of the property transferred. Abuses had resulted where properties subject to liabilities were transferred to different corporations, with the result that both corporations increased basis by the same liabilities. Applicable to transfers made after 10/18/98.

B. Distributions and Redemptions

1. Sharewell, Inc. v. Commissioner, T.C. Memo 1999-413 (12/21/99). One of taxpayer's shareholder-employees retired and his stock was redeemed pursuant to a contract calling for the retiring shareholder to be paid $1.3 million, of which $300,000 was deferred and represented by an assignment of certain accounts receivables. Twelve days after the agreement was signed, the taxpayer and the retiring shareholder executed a letter agreement denominated "non-compete agreement," whereby the retiring shareholder agreed not to compete for 3 years in consideration of the $300,000 of accounts receivable referred to in the shareholder agreement. Held: Even though the retiring shareholder reported the entire $1.3 million as amount realized on redemption of his stock, because there was (1) evidence of mutual mistake, (2) the non-compete agreement was subsequent to, not prior to, the purchase agreement, and (3) together the two written documents created an ambiguity, the *Danielson* [378 F.2d 771 (3d Cir. 1967)] rule, which had been adopted by the circuit to which the case was appealable, did not apply. On the facts, the parties had agreed to allocate $300,000 to the non-compete agreement, and because they had nontax adverse interests, i.e., the amount allocated to the non-compete would be deferred but the stock

purchase price would not be deferred, the allocation would be respected and taxpayer allowed an amortization deduction.

2. **Doctors are still pathologically addicted to tax shelters doomed to failure. Failed VEBA life insurance-based tax shelter results in constructive dividends.** Neonatology Associates, P.A. v. Commissioner, 115 T.C. No. 5 (7/31/00). In these consolidated cases, several employer / participants [doctors and medical professional associations] made contributions contributed to separate plans formed under two purported [§419A(f)(6) ten-or-more-employer] VEBAs "crafted by ... insurance salesmen ... and marketed to professional small business owners as a viable tax planning device." Each plan provided that a covered employee [usually a shareholder of the corporate employer] would receive term life insurance benefits. But the premiums on the underlying insurance policies substantially exceeded the cost of term life insurance because they funded not only the purchase of term insurance, but also "credits" that, together with interest on account in which the excess amounts were set aside, would be applied to convert, at the employee-beneficiary's option, the term insurance into individual universal life policies, with cash value, for each of the individual insureds. The conversion credits were earned over 120 months, but substantially vested only in the fifth year. As a result, after 5 years, a policyholder could withdraw any earned amount or borrow against it with no out-of-pocket expense. Judge Laro found that the plans were "marketed to professional, small business owners as a viable tax planning device [and] [t]he VEBA scheme was subscribed to by varied small businesses whose employee / owners sought primarily the advertised tax benefits and tax-free asset accumulation. The subject VEBAs were not designed, marketed, purchased, or sold as a means for an employer to provide welfare benefits to its employees."

- The court disallowed all of the §162 deductions for contributions to the plan in excess of the cost of group term life insurance [which was allowable under Reg. §1.162-10(a). The remainder of the contributions constituted distributions of "excess cash for the benefit of the employee/owners." As far as the corporate employers and their shareholder-employees who were plan beneficiaries were concerned, the excess contributions were constructive dividends in the year that the amounts were contributed to the plan. Judge Laro found no evidence that there was any intent that the excess amounts were compensation and found that the evidence positively supported the finding that the purpose and operations of the plans was to surreptitiously to provide a tax free savings device to the shareholder employees. That there was some possibility of forfeiture of the conversion credits [by failure to convert] and that they did not augment death benefits under the term life insurance part of the plan did not alter this conclusion. The forfeitability concepts of §83 do not apply to distributions [in contrast to compensation] from a corporation a to shareholder-employee.
- Section 6662(a) and (b)(1) penalties for negligence and intentional disregard of the rules and regulations were upheld. "Reliance" on the advice of the life insurance salesman (who was not a tax professional) regarding the tax consequences of the plan was not "reasonable." Nor does the preparation of returns by a CPA necessarily constitute "reliance" on the advice of a competent professional. The mere preparation of a return by a CPA does not mean that he has "opined" on any or all of the items reported in the return. But, Judge Laro declined to impose $25,000 penalties under §6673(a)(1)(B) for frivolous and groundless litigation because taxpayers did reasonably rely on the advice of trial counsel that their positions had merit.

3. *** Not enough business purpose for a corporate expenditure and too much personal benefit for the shareholder = constructive dividend. Tax Court finds a constructive dividend by reason of the corporation's payment that conferred an economic benefit on the shareholder.** Hood v. Commissioner, 115 T.C. No. 14 (8/25/00) (reviewed, no dissents). Corporation's payment of legal fees for the defense of its sole shareholder against a tax evasion charge from income unreported from the predecessor sole proprietorship were held to be a constructive dividend to the shareholder and therefore not deductible by the corporation.

- From 1978 through 1988 Hood had operated a sole proprietorship that was incorporated as HIF in 1988. Hood was sole shareholder and president. He was an indispensable employee of the corporation. There was no express agreement by HIF to assume the proprietorship's debts, but HIF paid the accounts receivable in the ordinary course. After HIF was incorporated, Hood was indicted and tried, but acquitted, for criminal tax evasion [§7201] and false declaration [§7206(1)] arising from the alleged failure to report income from the sole proprietorship. HIF paid the Hood's legal fees in connection with the criminal charges.

• The Tax Court (Judge Gale) held that the payment of legal fees was a constructive dividend because it primarily benefited the sole shareholder. Because the legal fees were Hood's obligation and HIF was not protecting its own interests – it had not been indicted; therefore, the corporation could not deduct the expenses. Even though Hood was indispensable to the corporation's business, the payment of his legal fees was not necessary because he had adequate personal assets. The court followed the Fifth Circuit's decision in *Jack's Maintenance Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir.1983), *rev'g. per curiam*. T.C. Memo.1981-349 and to the extent it was inconsistent overruled its own prior opinion [even though the Golsen rule did not apply]. Judge Gale held that the earlier Tax Court decision should not be followed because there was insufficient consideration to the possibility of a constructive dividend in that case.

• The Tax Court opinion in *Jack's Maintenance* found the legal fees to be deductible because the criminal charge had its origin in a business (rather than personal) situation; query whether tax evasion by a sole proprietor is a business-related matter. Therefore, the Tax Court in the earlier case permitted the legal fees to be deducted by the corporation because the shareholder was "essential" to the corporation's operation. In the current case, the Tax Court found that the payment was made primarily for the benefit of the shareholder.

C. Liquidations

1. Purchase price allocations in deemed actual asset acquisitions. REG-107069-97, 1999-36 I.R.B. 346, (64 F.R. 43461 8/10/99). Under the proposed regulations, there will be a total of VII classes of assets possible in an acquisition.

• Proposed regulations §1.338-1 through -10, §1.338(h)(10)-(1) and §1.1060-1 are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under sections 338 and 1060. The IRS identified three major deficiencies in the current regulations: (1) their statement of tax accounting rules and their relationship to tax accounting rules for asset purchases outside of §338; (2) the effects of the allocation rules; and (3) their lack of a complete model for the deemed asset sale (and, in the case of §338(h)(10) elections, the deemed liquidation) from which tax consequences not specifically set forth in the regulations can be determined. The proposed also take into account amendments to the Code enacted since the different portions of the current regulations were promulgated.

• The proposed regulations have four major aspects: (1) reorganization of the regulations; (2) clarification and modification of the accounting rules applicable to deemed and actual asset acquisitions; (3) modifications to the residual method mandated for allocating consideration and basis, increasing the number of classes to seven; and (4) miscellaneous revisions to the current regulations. Old target and new target (and any other affected parties, for example, when a §338(h)(10) election is made) must determine their tax consequences as if they actually had engaged in the sale and purchase transactions deemed to have occurred under §338. The consistency rules are unchanged.

• The seven classes are: Class I – cash and cash equivalents; Class II – CDs, securities, foreign currency; Class III – accounts receivable, mortgages, credit card receivables; Class IV – inventory; Class V – all assets not included in the other classes; Class VI – section 197 assets other than goodwill and going concern value; Class VII – section 197 goodwill and going concern value. The change relates to the addition of two new classes of "fast pay" assets, which must receive basis up to fair market value before there is any basis allocated to tangible property.

a. Purchase price allocations in deemed and actual asset acquisitions are promulgated as temporary regulations. T.D. 8858, 2000-4 I.R.B. (65 F.R. 1236, 1/7/00). The proposed regulations were promulgated as Temporary Regulations pending further review of comments on the proposed regulations and promulgation of final regulations. Effective 1/6/00.

2. Good news, bad news. Robson v. Commissioner, T.C. Memo. 2000-201 (6/29/00). If a corporation cancels a debt of a shareholder to the corporation in connection with the complete liquidation of the corporation, the transaction is not treated as cancellation of indebtedness income under §61(a)(12) subject to §108. Rather, the amount of the canceled debt is treated as an amount realized in exchange for the stock pursuant to the liquidation under §331, which results in capital gain treatment.

D. S Corporations

1. The story of what happens when §108 meets §1367. "[W]e must read the Internal Revenue Code as a whole." "The Internal Revenue Code 'should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction.'" Gitlitz v. Commissioner, 182 F.3d 1143, 99-2 U.S.T.C. ¶50,645, 84 A.F.T.R.2d 5059 (10th Cir. 8/6/99), *aff'g* Winn v. Commissioner, T.C. Memo. 1998-71, *withdrawing* T.C. Memo. 1997-286, *cert. granted*, 120 S.Ct. 1830 (5/1/00). Gitlitz and Winn each owned 50 percent of the stock of an S corporation that realized $2,021,096 of COD income. At that time the corporation was insolvent to the extent of $2,181,748. Thus all of the COD income was excluded under §108(a)(1)(B). Both shareholders had carried losses that had been suspended under §1366(d)(1) as well as operating losses that would be further suspended unless the excluded COD income increased their basis in their stock under §1367(a)(1).

a. The Tax Court followed its reviewed decision in Nelson v. Commissioner, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152, 99-2 U.S.T.C. ¶50,646, 84 A.F.T.R.2d 5067 (10th Cir. 7/6/99), which held that a shareholder of an insolvent S corporation may not increase his stock basis under §§1367(a)(1)(A) and 1366(a)(1)(A) by the amount of his pro rata share of the corporation's [excluded under §108(a)] discharge of indebtedness income on the theory that the COD income was passed-through exempt income. The Tax Court agreed with the IRS that §108(d)(7)(A) requires that the exclusion of income apply at the S corporation level, so that the reduction of tax attributes applied by §108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to exempt it totally from income.

b. Affirmed. 182 F.3d 1143, 99-2 U.S.T.C. ¶50,645, 84 A.F.T.R.2d 5059 (10th Cir. 8/6/99). The Court of Appeals for the Tenth Circuit affirmed, but on different reasoning. It assumed that the COD income was "tax exempt income" under §1366(a)(1)(A) which potentially could passthrough to the shareholders and increase basis. [fn 7] The court agreed with the Commissioner and the Tax Court, however, that §108(d)(7)(A) requires that the exclusion of income apply at the S corporation level, so that the reduction of tax attributes applied by §108(b) also applies at the corporate level and the discharge of indebtedness income never passes through to the shareholder. The court further concluded that §108(d)(4)(A) merely requires that attribute reduction is the last step in the calculations, it does not necessarily defer the attribute reduction until the year following the year in which the excluded COD income is realized. Thus, there was no corporate level income to pass through to the shareholders and to increase their basis. Furthermore, the reduction in tax attributes under §108(b) absorbed the shareholders losses carried over from prior years under §1366(d)(1).

c. Yeah, same here. Nelson v. Commissioner, 182 F.3d 1152, 99-2 U.S.T.C. ¶50,646, 84 A.F.T.R.2d 5067 (10th Cir. 7/6/99), *aff'g* 110 T.C. 114 (1998) (reviewed decision, 12-0-7). Taxpayer was the sole shareholder of an S corporation that realized cancellation of indebtedness (COD) income while it was insolvent. Under § 108(a), the corporation properly excluded the COD income. Upon the subsequent disposition of the stock (in the same year), the taxpayer-shareholder nevertheless claimed an increase in the basis of his stock in the corporation pursuant to §§1367(a)(1)(A) and 1366(a)(1)(A), on the theory that the COD income was passed-through "exempt" income, and reported a long-term capital loss on his 1991 Federal income tax return. The Commissioner disallowed a portion of the claimed long-term capital loss on the premise that § 108(d)(7)(A), which provides that for purposes of subchapter S the COD income exclusion is applied at the corporate level. The Tax Court upheld the Commissioner's position and denied the basis increase. Section 108, through the attribute reduction rules, is generally intended to defer the recognition of income, not to totally exempt it from taxation. The Court of Appeals affirmed on the basis of its decision in *Gitlitz*.

d. And the IRS says, "Let's put it in the Regs." In T.D. 8852, 64 F.R. 71641 (12/22/99), the IRS adopts the Tax Court's position in *Winn* and *Nelson* in final regulations under §1366, relating to the passthrough of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation. Reg. § 1.1366-1(a)(2)(viii), as amended, provides that COD income excluded at the corporate level under § 108 is not "tax exempt" income for purposes of §§1366 and 1367.

e. It's just too complicated for a district court judge — "The Internal Revenue Code is too complicated for courts to strain against the language in an effort to achieve a particular result." Hogue v. United States, 2000-1 U.S.T.C. ¶50,149 (D. Ore. 1/3/00). The district court judge (King) declined to follow either the Tax Court's reasoning in *Nelson* or the Tenth Circuit's reasoning in *Gitlitz* and allowed the shareholder's of an S corporation an increase in basis of their stock under §1366 for COD income that was excluded at the corporate level under §108 by reason of the corporation's insolvency. The court reasoned that the income was "exempt" and that the reduction of attributes occurred the following year. "If Congress or the IRS wish to prevent a windfall to the taxpayers, they can do so by changing the statute or regulations."

f. The Seventh Circuit sees things a bit differently. Witzel v. Commissioner, 200 F.3d 496, 2000-1 U.S.T.C. ¶50,165 (7th Cir. 1/18/00). The Seventh Circuit held that an S corporation shareholder is entitled to a stock basis increase when there is corporate-level COD income that is excluded under §108 by reason of the corporation's insolvency. However, the shareholder cannot deduct existing suspended losses because they were offset by the excluded COD income at the corporate level in the year in which the COD occurred. The court reasoned as follows:

> The Tax Court believes that COD income is not really tax exempt, because, as we know from section 108(b)(2)(A), such income reduces suspended losses by a dollar for every dollar of COD income and thus operates to defer rather than to eliminate tax. (The tax is paid when the suspended losses, having been reduced, are not available to offset taxable income in the future.) The Supreme Court said the same thing in passing in United States v. Centennial Savings Bank FSB, 499 U.S. 573, 580, . . . but, with all due respect, the Court's observation is not accurate. To the extent that the recipient of COD income (Witzel, to whom the income passed through his subchapter S corporation) never accrues suspended losses which that income reduces (thus reducing the tax benefits that they generate), his COD income will be tax exempt in the fullest sense; it will not generate tax liability even indirectly. More important, section 1366 is not limited to tax-exempt income, so if COD income is not 'really' tax exempt this would not take it out of the section.
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> . . . We offer this view tentatively . . . because a recently promulgated Treasury Regulation (not applicable to this case, however, because it applies only to tax years beginning on or after August 18, 1998) adopts the Tax Court's interpretation of section 1366 that we are criticizing. Treas. Reg. sec. 1.1366-1(a)(2)(viii) . . . The validity of the regulation is for the future; it is enough to rule today that section 108(d)(7)(A) requires that COD income of a subchapter S corporation be offset against any existing suspended losses arising from the operation of the corporation."

g. Maybe it really is a difficult issue. The Third Circuit produces yet a third distinct analysis and allows a current deduction in excess of the shareholder's economic investment. United States v. Farley, 202 F.3d 198, 2000-1 U.S.T.C. ¶50,179 (3d Cir. 1/27/00), *rev'g* 99-1 U.S.T.C. ¶50,370 (W.D. Pa. 3/3/99). The Third Circuit held that an S corporation's shareholder was entitled to increase his stock basis under §1367 for COD income that was not recognized by an insolvent S corporation under §108(a). It held that the district court, in ruling for the government, "ignored the unambiguous language of the controlling statutes." The COD income was exempt income that passed through under §1366. Losses previously suspended by reason of lack of adequate shareholder basis could be deducted immediately against the increased basis.

> The statutory language is unambiguous, and the operation of the statutory language is straightforward. Discharge of indebtedness income, considered income under section 61(a)(12), is excluded from gross income pursuant to section 108(a)(1)(B) if, as in this case, the S corporation is insolvent. This solvency determination is made at the corporate level rather than the individual shareholder level pursuant to section 108(d)(7)(A). Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholders' S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally, the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).

> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determining the tax imposed by this chapter for the taxable year of discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1). As such, the Farleys were entitled not only to increase the basis of their S corporation stock but also to take deductions for the Suspended Losses.

- The Third Circuit dismissed the Tenth Circuit's opinion in Gitlitz in the following words.

> The Tenth Circuit's interpretation of section 108(b)(4)(A) in *Gitlitz* ignores the plain meaning of the statute. Because we find that the language of section 108(b)(4)(A) is clear and unambiguous, we decline to follow the Tenth Circuit's holding in *Gitlitz* and hold that COD income excluded from gross income under section 108 passes through to the S corporation's shareholders, increasing the basis of their S corporation stock.

h. And the Eleventh Circuit decides yet another case without having to choose between the Seventh Circuit and Third Circuit views, but still delivers to the shareholder of an insolvent S corporation some gift-wrapped loss deductions manufactured out of thin air. Pugh v. Commissioner, 213 F.3d 1324, 2000-1 U.S.T.C. ¶50,514, 85 A.F.T.R.2d 1986 (11th Cir. 6/5/00). The court held that COD income excluded from gross income by an S corporation does pass through to a shareholder, resulting in an immediate increase in shareholder basis. This is so even when the corporation has no suspended losses / NOLs because the shareholder has no suspended losses and the corporation has no property, the basis of which can be reduced under §108(b). As result, the shareholder was allowed an increased capital loss on the worthlessness of his stock — a loss which was entirely artificial because it represented borrowed money that were neither repaid not even included in income.

i. And the Sixth Circuit agrees with the Seventh. More deductions for losses that never occurred. Gaudiano v. Commissioner, 216 F.3d 524, 2000-2 U.S.T.C ¶50,559, 86 A.F.T.R.2d 5065 (6th Cir. 6/8/00). On appeal, the court held that the COD income was tax-exempt income that increased taxpayers' basis in their S corporation stock, but taxpayers were not entitled to deduct suspended losses because those losses were offset at the corporate level by the COD income realized by the corporation. Judge Nugent stated:

> While this is a very close call, we feel inclined to follow the reasoning of the Tenth and Seventh Circuits on the ordering issue. Section 108 (d)(7)(A) clearly requires that the insolvency determination and the attribute reduction take place at the corporate level. If the attribute reduction is made after the COD income passes through then there will be no attribute reduction at the corporate level. As the Commissioner notes, the mandated reduction of the corporation's net operating losses (which include suspended shareholder losses) would never occur since there would be no income left at the corporate level to apply against the losses. While § 108(b)(4)(A) provides that the reduction in attributes shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge, it does not preclude the reduction of certain attributes in the year of discharge. Specifically, § 108(b)(4)(B) provides that reductions of net operating loss for the taxable year of discharge and any net operating loss carryover and any capital loss carryover shall be made "first in the loss for the taxable year of discharge." Thus, the corporation must determine its net operating losses and suspended operating losses for the year of discharge and reduce those attributes by the amount of COD income realized. If the losses exceed the COD income, then the extra losses pass through to the shareholders.
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> We disagree with the Tax Court and the Tenth Circuit in their findings that COD income is not income within the meaning of § 1366(a)(1)(A) and thus does not pass through to the shareholders and increase the basis of their shares. Section 1366 (a)(1)(A) explicitly includes tax-exempt income. The Tax Court and the Tenth Circuit have determined that COD income is not really tax-exempt since COD income reduces suspended losses and thus operates to defer rather than eliminate taxes. However, as Judge Posner explained in

Witzel, COD income is not always tax deferred; it may be truly tax exempt if there are no suspended losses to offset the income. Moreover, § 1366 is not "limited to tax-exempt income, so if COD income is not 'really' tax exempt this would not take it out of the section. *Witzel*, 200 F.3d at 498.

Since COD income falls within § 1366(a)(1)(A), it follows that pursuant to § 1367(a)(1)(A), COD income increases the basis of the S corporation shareholder's stock by the amount of COD income passed through to the shareholder. Consequently, we hold that the S corporation must reduce any existing tax attributes, including shareholder suspended losses, by the amount of COD income realized by the S corporation. If any COD income remains after losses and suspended losses are deducted, that income may flow through to the shareholders pursuant to § 1366 and increase the shareholder's basis pursuant to § 1367. The shareholder may then use his increased basis to deduct any losses that may accumulate in the future.

j. **And the Supremes will the sing the answer – certiorari granted to the Tenth Circuit in *Gitlitz*.** The Supreme Court has agreed to resolve the split in the circuits. *Gitlitz v. Commissioner*, 120 S.Ct. 1830 (5/1/00).

2. **Final Passthrough and Basis Adjustment Regulations.** T.D. 8852, Passthrough of Items of an S Corporation to its Shareholders, 2000-2 I.R.B. 253 (12/13/99), proposed in REG-209446-82 (63 F.R. 44181, 8/18/98). Amended Regs. §1.1366-1 through §1.1366-5, §1.1367-1(e), (f), (g), (h) and (j), §1.1366-3, §1.1368-1(d), (e), §1.1368-2, §1.1368-3, and §1.1368-4, dealing comprehensively with the passthrough of subchapter S corporation income and basis adjustments. The final regulations adopt the proposed regulations with a few modifications.

- The final regulations clarify that the allocation of any tax under §1375 is based on the total net passive investment income for the taxable year.
- The final regulations make clear that when a net negative adjustment occurs, the AAA is adjusted to take into account distributions before the AAA is adjusted to take into account any net negative adjustment.
- Reg. § 1.1366-1(a)(2)(viii), as amended, provides that COD income excluded at the corporate level under §108 is not "tax exempt" income for purposes of §§1366 and 1367.

3. **No surprise here.** Ding v. Commissioner, 200 F.3d 587, 2000-1 U.S.T.C. ¶50,137 (9th Cir. 12/30/99). For purposes of computing self employment tax, a shareholder-employee of an S corporation cannot deduct passed-through S corporation losses against Schedule C income from a sole proprietorship. Rev. Rul. 59-221, 1959-1 C.B. 225, followed.

4. Grojean v. Commissioner, T.C. Memo 1999-425 (12/29/99). An S corporation shareholder who acquired a loan participation interest in a loan from a bank to his wholly-owned S corporation, as required by the lender, by borrowing from the bank was a mere guarantor. The shareholder's note and the corporation's note had identical terms and the bank automatically credited payments on the corporation's note against the shareholder's note. No cash passed hands between the shareholder and bank in the circular transaction, and shareholder made no economic outlay. The shareholder acquired no additional basis to support passed-through losses.

5. **Proposed regulations regarding the QSub election have been finalized.** T.D. 8869, Subchapter S Subsidiaries, 2000-6 I.R.B. 498 (2/14/00), proposed in REG-251698-96, 1998-20 I.R.B. 14. A qualified subchapter S subsidiary (QSub) is any domestic corporation that (1) is not an ineligible corporation, (2) is wholly owned by an S corporation, and (3) for which the parent S corporation elects to treat as a QSub. §1361(b)(3)(B). Election procedures are described in Reg. §1.1361-3(a). A corporation for which a QSub election is made is not treated as a separate corporation. Transactions between the S corporation parent and the qualified S corporation subsidiary are not taken into account for tax purposes. All assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Reg. §1.1361-4(a)(1). The existence of the stock of a QSub is ignored for tax purposes. Reg. §1.1361-4(a)(4). If a QSub election is made for a newly formed subsidiary, the subsidiary is treated as a QSub from its inception–the parent and subsidiary both are treated as if the subsidiary never had been formed. In the case of a preexisting subsidiary, as a result of a QSub election the subsidiary is deemed to

have liquidated under §§332 and 337 immediately before the election is effective. Reg. §1.1361-4(a)(2), (b).

- Reg. §1.1361-3(a)(4) allows the effective date of a QSub election to be any specified date within 2 months and 15 days prior to, or not more than 12 months after, the date the election is made. Unlike an S election, a QSub election does not have to be made within 2 months and 15 days of the beginning of a taxable year.
- A QSub election may be revoked as of any specified date within 2 months and 15 days prior to, or not more than 12 months after, the date of the revocation. Reg. §1.1361-3(b)(2). A QSub that ceases to qualify under §1361(b)(3)(B) or whose election has been revoked is treated as a new corporation that has acquired all of its assets and assumed all of its liabilities from its S corporation parent in exchange for the subsidiary's stock immediately before the cessation of QSub status. §1361(b)(3)(C); Reg. §1.1361-5(b)(1). This hypothetical transaction is governed by general income tax principles, including §351 and its associated sections. For purposes of determining control under §351, equity instruments that are not treated as a second class of stock under §1361(b)(2)(D) are disregarded. The regulations also provide that the step transaction doctrine is applicable. Thus a disposition of the stock of the former QSub will affect application of §351. Reg. §1.1361-5(b)(3), Ex. (1). A QSub whose election has terminated may not have a QSub election made with respect to it (or, if its stock is acquired by eligible shareholders, make an S election itself) before its fifth taxable year that begins after the first taxable year for which the termination is effective without the Service's consent. §1361(b)(3)(D); Reg. §1.1361-5(c). If a QSub election is terminated by reason of the disposition of the stock of the subsidiary by the parent, the new owners may make an immediate S election, without the consent of the IRS, provided that there has been no intervening period in which the corporation was a C corporation. Reg. §1.1361-5(c)(2).

E. Affiliated Corporations.

1. REG-106219-98, proposed regulations amending Reg. §1.1502-76 on consolidated group acquisition of 80 percent or more of an S corporation's stock (63 F.R. 69581, 12/17/98). The regulations provide that the S corporation becomes a member of the group at the beginning of the day of its acquisition and its tax year ends at the end of the previous day.

a. T.D. 8843, final consolidated return regulations that provide specific rules that apply to the acquisition of the stock of an S corporation by a member of the consolidated group (64 F.R. 61205, 11/10/99).

2. ***Losses suffered by a profitable corporation were not part of a group's consolidated net operating loss.** Intermet Corp. v. Commissioner, 111 T.C. 294 (12/8/98). For 1992, the taxpayer's consolidated group reported a consolidated net operating loss of nearly $26 million. Three of the members of the group reported positive taxable income but reported deductions of $1,226,000 that arguably were specified liability loss deduction items within the meaning of §172(f)(1). [The items were state and local taxes and interest on federal taxes relating to a year more than three years before 1992.] Judge Wells held that under Reg. §§1.1502-12 and 1.1502-21A, the group's specified liability losses did not include the deductions in question because members of the group that reported positive separate taxable income did not contribute to the group's consolidated NOL. Accordingly, the 10-year carryback period of §172(b)(1)(C) did not apply with respect to a portion of the consolidated NOL equal to the items in question. [The court did not reach the question of whether the items were specified liability losses under §172(f)(1), as in effect for 1992, in the first place.]

a. ***But on appeal the taxpayer wins.** 209 F.3d 901, 2000-1 U.S.T.C. ¶50,382, 85 A.F.T.R.2d 1387 (6th Cir. 4/20/00). The Court of Appeals assumed that the losses in question were specified liability losses [because the Tax Court did not reach the issue], and allowed them to be carried back. The court reasoned that the subsidiary's specified liability loss deduction items reduced the subsidiary's separate taxable income dollar-for-dollar and thus contributed to the consolidated NOL. An individual component member's taxable income has no independent significance; it is merely a step in computing the consolidated NOL. There was no basis in Reg. §1.1502-21A for treating a specified liability loss as constituting part of the consolidated NOL when the member that incurred the deduction had negative taxable income but not when that member had positive separate taxable income [as long as a SRLY year is not involved].

3. On the same issue, the Fourth Circuit reversed a district court decision and found in favor of the Government. United Dominion Industries, Inc. v. United States, 208 F.3d 452, 2000-1 U.S.T.C. ¶50,310 (4th Cir. 3/24/00). Consolidated group may not carry back separate return product liability expenses, i.e., product liability expenditures by profitable corporations, because these do not enter into the consolidated net operating loss, and the statute speaks of specified liability losses – not specified liability expenses. Instead, only that portion of a member's separate net operating loss attributable to specified liability losses may enter into the computation of the portion of the consolidated NOL attributable to specified liability losses.

4. Consolidated return duplicated loss disallowance Regs are valid. Rite Aid Corp. v. United States, 2000-1 U.S.T.C. ¶50,429, 85 A.F.T.R.2d 1439 (Fed. Cl. 4/21/00). Reg. §1.1502-20, which, subject to certain exceptions, disallows *any* loss realized by a member of a consolidated group upon the disposition of the stock of a subsidiary, is valid and is not in derogation of §165. Under Reg. §1.1502-20, the amount of loss that is disallowed is limited to the sum of (1) income or gain resulting from "extraordinary gains dispositions", which are defined as dispositions of capital assets, depreciable property used in the trade or business, certain bulk asset dispositions, and discharge of indebtedness income, (2) positive investment adjustments (other than those attributable to extraordinary gain dispositions), and (3) "duplicated loss," which is the aggregate of the subsidiary's asset bases and loss carryovers over the value of the subsidiary's assets. Any losses in excess of these amounts is deductible. Reg. §1.1502-20 is designed to prevent "duplicated losses" — the deduction by both the parent and subsidiary of the same economic loss. Rite Aid sold a subsidiary (Encore) and realized a taxable loss of $33 million and an "economic loss" of $22 million, which it claimed should be deductible. The court held that because Encore's built-in loss of $28 million [as calculated by Rite-Aid] exceeded Rite-Aids' economic loss, no loss deduction was allowed. The court pointed out that Rite Aid could have avoided Reg. 1.1502-20 by finding a buyer who would agree to a §338(h)(10) election.

5. *Zero basis no more. T.D. 8883, final regulations under §1032 on use of parent's stock by subsidiary to acquire property or services (65 F.R. 31073, 5/16/00). The requirement that the subsidiary "immediately" use the parent's stock to acquire the goods or services was retained from the proposed regulations.

a. REG-106221-98, proposed regulations under §1032, relating to the treatment of a disposition (the acquiring corporation) of the stock of another corporation (the issuing corporation) in a taxable transaction (63 F.R. 50816, 9/23/98). Holds that if acquiring corporation receives issuing corporation stock in a §362(a) transaction and immediately transfers the stock for money or other property in a purchase-type transaction, then the transaction is treated as if the acquiring corporation had purchased the issuing corporation's stock at fmv with cash contributed by the issuing corporation immediately before the transaction.

6. So just when will this suspended loss be allowed? Textron, Inc. v. Commissioner, 115 T.C. No. 6 (8/7/00). In 1967, when AVCO acquired Paul Revere (PR) and PR became part of the AVCO group, PR owned 4 million shares of AVCO. In 1977, AVCO redeemed its shares owned by PR, and pursuant to former Reg. §1.1502-14(b)(1), PR did not recognize its loss, but pursuant to former Reg. 1.1502-31(b)(2)(ii) PR's basis in the stock was reallocated to the note. In 1987, after AVCO had been acquired by Textron, AVCO redeemed the note held by PR, on which PR realized a $15,000,000 loss, following which PR was liquidated into AVCO in a §332 liquidation. Judge Laro agreed with the Commissioner that former Reg. §1.1504-14(d)(4)(i) "deferred" PR's loss in 1987 [because the note was received in exchange for property, i.e., AVCO stock, in an exchanged basis transaction and the note was never held by a nonmember]. Judge Laro held that the determination of whether a note has been held by a nonmember under former Reg. §1.1502-14(d)(4)(i)(c) looks to whether the holder of the note is a nonmember at the time of the redemption, not to whether the holder of a note was a nonmember when the note was received when the holder becomes a member before the redemption. Finally, under former Reg. §1.1502-14(d)(4)(ii) and (e)(2), the liquidation of PR in a §332 liquidation did free-up the suspended loss because AVCO inherited PR's tax characteristics.

- The analytical methodology of the Textron opinion is at odds with Tax Court Judge Wells's opinions in CSI Hydrostatic Testers v. Commissioner, 103 T.C. 398 (1994) and Intermet

Corp. v. Commissioner, 111 T.C. 294 (12/8/98), rev'd, 209 F.3d 901(6th Cir. 4/20/00).[2] Those cases strictly construed the consolidated return regulations even though the results were difficult to support theoretically. In contrast, in Textron, Judge Laro interpreted Reg. §1.1502-14(d)(4)(i) in a manner that is difficult to justify under the literal language, but which reached a sensible theoretical result [under the single -entity theory of consolidated returns. He concluded that Reg. §1.1502-14(d)(4)(i) required PR to defer its loss on the redemption of the obligation it received for its AVCO stock even though one of the conditions for that section to apply, is that the obligation "never have been held by a nonmember." Since PR acquired the obligation before it became a member of the Textron group that redeemed the obligation, Judge Laro's conclusion that membership status was determined at the time that the obligation was redeemed effectively read out of the rule the word. He could have more effectively reached the same result by looking to former Reg. §1.1502-13(f)(2) to note that the AVCO group was a predecessor group to the Textron, so that Paul Revere should not have been considered ever to have been a nonmember.

- Note that if the redemption by AVCO of the its stock held by PR had occurred after July 12, 1995, the loss would have been permanently disallowed under Reg. §1.1502-13(f)(6), which disallows any loss to a member on the sale or exchange of stock of the common parent corporation of a consolidated group. Under current regulations, if AVCO and PR both had been subsidiary members of the same consolidated group and the redemption were described in §302(a) – which would be unlikely – Reg. §1.1502-20(a) would disallow the loss, although a portion of it might be allowed under Reg. §1.1502-20(c). Section 267(f) would not defer the loss because Reg. §1.267(f)-1(c)(1) adopts the acceleration rule of Reg. § 1.1502-13(d). The loss might, however, be subject to the anti-avoidance rules of both Reg. §1.267(f)- 1(h) and §1.1502-13(h).

7. Notice 2000-53, 2000-38 I.R.B. 293 (9/1/00). The IRS will promulgate regulations providing elective transitional relief from retroactive repeal of the SRLY rules when §382 or §383 applies, as provided in T.D. 8823 (Consolidated Returns–Limitations on the Use of Certain Losses and Deductions), 1999-29 I.R.B. 34, amending Reg. §§1.1502-15, -21, and -22.

F. Section 482

1. The **Tax Relief Extension Act of 1999** amended §6103(b)(2) to include within the definition of "return information" an advance pricing agreement (APA) under §482, as well the application and any background information submitted in connection with the application for the APA.

G. Reorganizations and Corporate Divisions

1. ***What, a little theoretical consistency across types of reorganizations – What will they think of next?** The Solely for Voting Stock Requirement in Certain Corporate Reorganizations, REG-115086-98, 1999-26 I.R.B. 6 (64 F.R. 31770, 6/14/99). Prop. Reg. §1.368-2(d)(4)(i) - (iii) would vitiate the application of the *Bausch & Lomb* doctrine in §368(a)(1)(C) stock-for-asset reorganizations. The new rules will be effective upon publication of final regulations, subject to the usual grandfathering of transactions pursuant to a binding agreement at that time.

- Bausch & Lomb Optical Co. v. Commissioner, 30 T.C. 602 (1958), aff'd, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959), upheld the IRS's position in Rev. Rul. 54-396, 1954-2 C.B. 147, that the acquisition of assets of a partially controlled subsidiary cannot not qualify as a tax-free reorganization under §368(a)(1)(C). The rationale of the Bausch & Lomb doctrine is that the acquisition violates the solely for voting stock requirement, because the parent corporation acquires only part of the subsidiary's assets in exchange for its voting stock, with the remaining portion of the subsidiary's assets being acquired in a liquidating distribution in exchange for previously held stock of the subsidiary.
- The Bausch & Lomb doctrine has been criticized because (1) a transaction in which a parent corporation converts an indirect ownership interest in a subsidiary's assets to a direct interest does not resemble a sale, and (2) the taxable treatment of the "upstream" type (C) reorganization under the Bausch & Lomb doctrine inconsistent with the tax-free treatment of the "upstream" type (A) reorganization.
- Under the proposed regulations, preexisting ownership of a portion of a target corporation's stock by an acquiring corporation generally will not negate satisfaction of the solely for voting stock requirement in a (C) reorganization. If in connection with a potential (C) reorganization the acquiring corporation acquires any target corporation's stock for consideration other than its own voting stock (or its

[2] We are indebted to Prof. Don Leatherman, University of Tennessee College of Law, for insightful suggestions regarding the analysis of the *Textron* case.

parent's voting stock if the parent's stock is used in attempted (C) reorganization), whether from a shareholder of the target corporation or from the target corporation itself, such consideration will be treated as money or other property exchanged by the acquiring corporation for the target corporation's assets for purposes of applying the boot limitation in §368(a)(2)(B). Whether there has been an acquisition in connection with a potential (C) reorganization of a target corporation's stock for consideration other than voting stock. will be made on the basis of all of the facts and circumstances.

a. Notice 2000-1; 2000-2 I.R.B. (12/21/99). changes effective date of proposed regulatons to transactions occurring after 12/31/99. Taxpayers may also obtain letter rulings permitting them to apply the proposed regulations to transfers taking place on or after 6/11/99.

b. Regulations are made final. T.D. 8885, final *Bausch & Lomb* repeal regulations on creeping C regulations (65 F.R. 31805, 5/19/00).

2. ***Divisive transactions fail to qualify as A reorganizations despite being accomplished under a state [Texas] "merger" statute.** Rev. Rul. 2000-5, 2000-5 I.R.B. (1/19/00). Transactions in which (1) a target corporation "merges" under state law with and into an acquiring corporation [but does not go out of existence], or (2) a target corporation "merges" under state law with and into two or more acquiring corporations [and goes out of existence], do not qualify as mergers under §368(a)(1)(A).

a. *Definition of "merger" revised in new proposed regulation. REG-106186-98, proposed regulations on mergers involving disregarded entities (65 F.R. 31115, 5/16/00). Proposed Reg. §1.368-2(b)(1) would be revised to require that by operation of state, etc. merger law **"the transaction must result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist"** [with similar requirements for consolidations]. Mergers involving disregarded entities are not "A" reorganizations.

- These proposed regulations would encompass the matters ruled upon in Rev. Rul. 2000-5, relating to the Texas "merger" statute.

3. ***What continuity of interest?** Rev. Rul. 99-58, 1999-52 I.R.B. 701 (12/27/99). The open market purchase of its shares by a publicly traded corporation following a tax free reorganization in which the shareholders of the target corporation received 50 percent cash and 50 percent stock does not violate the continuity of interest requirement under Reg. §1.368-1(e), even though the acquiring corporation's intent to repurchase shares [to prevent dilution] had been announced prior to the reorganization, because the repurchase was not negotiated with the target or its shareholders and there was no "understanding" between the acquiring corporation and the target shareholders that their ownership would be transitory.

4. **Guidance under section 356 relating to the treatment of nonqualified preferred stock and other preferred stock in certain exchanges and distributions,** REG-105089-99, 2000-6 I.R.B. 580 (65 F.R. 4203, 1/26/00). The Taxpayer Relief Act of 1997 amended §§351, 354, 355, 356, and 1036 to provide that nonqualified preferred stock (as defined in section 351(g)(2)) (NQPS) received in an exchange or distribution will not be treated as stock or securities but, instead, will be treated as "other property" or "boot." Under §§354(a)(2)(C), 355(a)(3)(D), and 356(e)(2), NQPS is treated as stock, and not other property, in cases where the NQPS is received in exchange for, or in a distribution with respect to, NQPS. As a result, the receipt of NQPS in exchange for NQPS will not result in gain or loss recognition. Nonqualified preferred stock (as defined in §351(g)(2)) received in an exchange will not be treated as stock or securities but, instead, will be treated as "other property" or "boot." As a result, the receipt of nonqualified preferred stock will result in recognition of gain under '356 unless a specified exception applies. Sections 354(a)(2)(C), 355(a)(3)(D), and 356(e)(2) provide that nonqualified preferred stock is treated as stock rather than as other property in cases where the nonqualified preferred stock is received in exchange for, or as a distribution on, other nonqualified preferred stock. As a result, the receipt of nonqualified preferred stock in such an exchange will not result in recognition of gain under §355 or §356 (or loss). Prop. Regs. §§1.354-1(f), 1.355-1(d), and 1.356-7(c) would provide additional rules to deal with various aspects of exchanges of nonqualified preferred stock in reorganizations. Under the general rule in the proposed regulations, the nonrecognition rule would apply only if nonqualified preferred stock is received with respect to "substantially similar" nonqualified preferred stock.

5. A cozy change in the COSI Regulations. T.D. 8898, Continuity of Interest, (65 F.R. 52909, 8/31/00), proposed in REG-120882-9, 1998-14 I.R.B. 25 (1/28/98) and promulgated as Temporary Regulations, T.D. 8761, 1998-14 I.R.B. 13 (1/28/98). Final COSI regulations, Reg. §1.368-1(e)(1)(ii) and (e)(6), Ex.9, [generally effective 8/30/00] dealing with the effect of pre-reorganization redemptions on the continuity of shareholder interest requirement in corporate reorganizations. The proposed and temporary regulations had provided that for purposes of determining whether the shareholder continuity of interest requirement had been satisfied in connection with a potential reorganization, a shareholder's proprietary interest in the target corporation (T) would not be treated as preserved if prior to and in connection with the acquisition the shareholder's stock was redeemed or to the extent that an extraordinary distribution is made with respect to the stock. In essence, the temporary and proposed regulations treated preacquisition redemptions and distributions as if they were cash boot payments by the acquiring corporation.

- In response to critical comments [including some emphasizing the practice of withdrawing as much of the AAA as possible before the acquisition of an S corporation by a C corporation], the final regulations are substantially different. Final Reg. §1.368-1(e)(1)(ii) provides that in the event of a preacquisition redemption of its stock or extraordinary distribution by the target corporation (other than one held by the acquirer (P)) the shareholder's proprietary interest is not preserved only to the extent that consideration received prior to the potential reorganization is treated as boot received from P (or a related party) in exchange for T stock for purposes of §356 (or would be so treated if the T shareholder also had received P stock in exchange for T stock owned by the shareholder [thus dealing with pre-acquisition complete redemptions of one or more shareholders]). All of the facts and circumstances, as well as other sections of the regulations and general principles of tax law, are taken into account in making this determination.

6. Backing into control within 5 years of the spin-off backed them right out of §355. McLaulin v. Commissioner, 115 T.C. No. 18 (9/20/00). The taxpayers were shareholders of RPI, an S corporation. Until 1993, RPI owned 50 percent of the stock of Sunbelt (a C corporation); the other 50 percent was owned by Hutto. In 1993, after protracted negotiations regarding whether RPI should purchase Hutto's stock in Sunbelt or Hutto should purchase RPI's Sunbelt stock, Sunbelt redeemed all of Hutto's stock for cash [$828,943], which was borrowed from RPI, and property [$101,000], leaving RPI as Sunbelt's sole shareholder. Later on the same day as the redemption, RPI distributed all of the stock of Sunbelt to RPI's three equal shareholders – the taxpayers — in a transaction intended to qualify as a tax-free spinoff under §355. The stated purposes of the distribution were to relieve RPI from any potential liabilities arising from Sunbelt's operations, to prepare Sunbelt to go public, and to preserve RPI's S election [the controlling version of §1361(b) for the year in question prohibited the parent of an affiliated group from being an S corporation].

- The Tax Court (Judge Halpern) held that because RPI's distribution of the stock of Sunbelt occurred less than 5 years after RPI acquired control of Sunbelt in a transaction in which gain or loss was recognized [i.e., the redemption of Hutto's stock], the distribution failed to satisfy the active business requirement of §355(a)(1)(C) and (b)(2)(D)(ii). Judge Halpern rejected the taxpayer's "blanket assertion" that a redemption of stock of the other shareholder's stock, thereby backing the parent into control of the subsidiary, never could be treated as the acquisition of control within 5 years in a taxable transaction. He likewise declined to follow the Commissioner's argument directly to apply Rev. Rul. 57-144, 1957-1C.B. 123, which would treat any instance in which a redemption resulted in the acquisition of control within 5 years as a disqualifying acquisition. Rather, he emphasized the negotiations leading up to the transaction and the fact that the cash for the redemption came from RPI to conclude that in this case there was no difference between the transaction as it occurred and a direct purchase by RPI.
- Accordingly, §335(c)(1) did not apply to provide nonrecognition at the corporate level; under §311(b), RPI recognized gain on the distribution of the Sunbelt stock, and the gain passed through to the RPI shareholders under §1366(a). [The court did not address the Commissioner's argument that the shareholders failed to prove that the distribution was designed to achieve a corporate business purpose as required by Reg. §1.355-2(b).]

7. No COBE, not even close. Honbarrier v. Commissioner, 115 T.C. No. 23 (9/29/00). The taxpayer was the sole shareholder of T Corp, which for many years prior to 1988 was in the freight trucking business. Between 1988 and 1990, T Corp liquidated its freight business and invested the proceeds from the sale of its operating assets in tax-exempt bonds and a municipal bond fund. [T Corp. had been an S corporation until 1992; starting in 1993 T was a C corporation.] On 12/31/93, T Corp was merged into A Corp., a trucking company in which the taxpayer owned the majority of the stock [his wife and children owning the remainder], in a transaction in which the taxpayer received solely A Corp stock. A Corp was an S corporation. Two months before the merger, T Corp held approximately $7.35 million of tax-exempt bonds and bond funds and a small amount of cash. On the day of the merger, T liquidated one of its tax-exempt bond funds and its municipal bond fund, and its assets consisted of $2,415,321 in cash, $4,849,146 in tax-exempt bonds, $37,800 in interest and dividends receivable, $18,926 in money funds, and an ICC operating authority. Before the merger, A Corp. did not hold any tax-exempt bonds; it held cash balances in short-term investments, such as CDs. Immediately following the merger, A Corp. distributed $7 million to its shareholders, which they treated as a tax-free distribution from T's AAA [which exceeded $10 million] under §1368(c)(1). The distribution consisted of $2,450,854 in cash and tax-exempt bonds worth $4,549,146 that had been acquired from T Corp. Within 4 months, A Corp disposed of the remaining tax-exempt bonds that it acquired from T Corp. The taxpayer and the corporations treated the transaction as a tax-free reorganization under §368(a)(1)(A).

- The Tax Court (Judge Ruwe) upheld that Commissioner's assertion that the merger was not a tax-free reorganization because the COBE requirement of Reg. §1.368-1(d) had not been satisfied.. T Corp. had abandoned its trucking business long before the merger and had entered into the business of holding tax-exempt bonds and bond funds. This investment business was T Corp's historic business at the time of the merger. A Corp. neither continued the T Corp's historic business nor used a significant portion of T Corp's historic business assets in a business conducted by A Corp. Therefore, the taxpayer recognized all of the gain realized gain with respect to the T stock disposed of in the merger. T Corp. did not realize any gain in merger because the basis of its assets equaled their fair market value.

H. Corporate Tax Shelters

1. Tax shelter benefits from §453 contingent sale partnership tax shelter not allowed because the tax shelter is a sham and "serves no economic purpose other than tax savings." Merrill Lynch's persistence overcomes initial doubts of tax department. ACM Partnership v. Commissioner, T.C. Memo. 1997-115 (3/5/97). Judge Laro found a §453 contingent sale partnership tax shelter to be a prearranged sham, "tax-driven and devoid of economic purpose," and "serv[ing] no economic purpose other than tax savings," following *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966). Under the scheme to shelter Colgate's $105 million 1988 capital gain, a partnership was formed in 1989; its three partners were affiliates of (a) a foreign bank (about 90%), (b) Colgate (about 9%), and (c) Merrill Lynch (about 1%). A bank note was purchased by the partnership and immediately sold for a large immediate payment and much smaller future contingent payments. Under the contingent payment sale provisions of the temporary regulations [§15a.453-1(c)] the partnership's basis was to be allocated ratably over the several years over which contingent payments could be made, resulting in a large 1989 installment sale gain to the partnership. The lion's share of that installment sale gain was allocated to the foreign bank (which was not taxable on U.S. source capital gain), followed by the redemption of the foreign bank's partnership interest. This left Colgate as the 90 percent partner. In 1991, the installment sale obligation was sold by the partnership, triggering about $100 million of capital losses, which Colgate attempted to use to shelter its 1988 capital gain.

a. ACM affirmed by Third Circuit, except for determination that out-of-pocket amounts are deductible. ACM Partnership v. Commissioner, 157 F.3d 231, 98-2 U.S.T.C. ¶50,790 (3d Cir. 10/13/98) (2-1), aff'g and rev'g T.C. Memo. 1997-115. Affirms Tax Court on its application of the "economic substance" doctrine, which eliminated the capital gains and losses attributable to ACM's application of the ratable basis recovery rule of the contingent installment sale provisions.

2. Judge Foley finds another Merrill Lynch §453 partnership plan does not work because, under the facts, there was no partnership. ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305 (8/20/98). In another Merrill Lynch §453 partnership plan to create capital losses to shelter earlier capital gains, AlliedSignal, lost when Judge Foley held that the parties to the partnership agreement did not join together for a common purpose of investing in interest-bearing instruments, and they did not share profits and losses.

a. *Affirmed, ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 2000-1 U.S.T.C. ¶50,185 (D.C. Cir. 2/1/00). The D.C. Circuit's opinion noted that it disagreed with the

Tax Court's statements that persons with "divergent business goals" are precluded from having the requisite intent to form a partnership; however, this view was not essential to the Tax Court's conclusion that the parties did not intend to join together as partners to conduct business activity for a purpose other than tax avoidance. The court held that there was a single business purpose rule.

3. **Judge Nims follows ACM to deny benefits to Brunswick.** Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (10/27/99). Brunswick's transactions identical to ACM's were found to lack economic substance. Judge Nims held that the transactions lacked nontax business purposes and that Congress did not intend to favor such transactions "regardless of their economic substance." He held that fees paid for the organization of the partnership were deductible subject to the limitations of §709(b) [60-month amortization], but that the fees paid with respect to the sham transactions were not deductible.

4. **Step-down preferred [fast-pay stock] to be recharacterized.** REG-104072-97, 64 F.R. 805 (1/6/99). Proposed regulations that recharacterize for tax purposes, financing arrangements involving fast-pay stock. Economically, fast-pay stock is self-amortizing because distributions are in part a return on investment and in part a return of the investment, which understates the taxable income on the benefited stock during the initial period. Follows Notice 97-21, except that a different model is used that treats the benefited shareholders as first issuing the financing instruments in exchange for cash equal to the fast-pay stock's fair market value, and then as contributing the cash to the corporation (which increases their basis in the benefited stock). Grandfather that limits taxable income to that provided in Notice 97-21 until these regulations become final.

a. ***Finalized.** T.D. 8853, 2000-4 I.R.B. 377 (1/7/00). Simplifies the definition of "fast-pay arrangement" to any arrangement by which a corporation has fast pay stock outstanding for any part of its taxable year. Changes the rule in the proposed regulations that any redemption that results in dividend treatment results in fast-pay stock; under the final regulations. Stock is not fast pay stock solely because a redemption results in dividend treatment exists unless there is a principal purpose to achieve the effect of fast pay stock. Effective date, February 27, 1997 (with some transition relief).

5. ***Springstein isn't the only BOSS; tax avoidance using distributions of encumbered property.** Notice 99-59, 1999-52 I.R.B. 761, advises taxpayers that losses from "BOSS" product transactions are not properly deductible. The Notice describes the BOSS product as follows:

> In one typical arrangement, taxpayers act through a partnership to contribute cash to a foreign corporation, which has been formed for the purpose of carrying out the transaction, in exchange for the common stock of that corporation. Another party contributes additional capital to the corporation in exchange for the preferred stock of that corporation. The foreign corporation then acquires additional capital by borrowing from a bank and grants the bank a security interest in securities acquired by the foreign corporation that have a value equal to the amount of the borrowing. Thereafter, the foreign corporation makes a distribution of the encumbered securities to the partnership that holds its common stock. The effect of the distribution, combined with fees and other transaction costs incurred at the corporate level, is to reduce the remaining value of the foreign corporation's common stock to zero or a minimal amount. Although the distributed securities are encumbered by the bank debt (and the taxpayers or their partnership may be secondarily liable for the debt as guarantors), the foreign corporation has sufficient other assets to repay the debt, and it is the understanding of all parties that the foreign corporation will repay the debt with such other assets.
>
> For example, if the taxpayers' partnership had contributed $100x for the common stock of the foreign corporation, the partnership might receive a distribution of securities with a fair market value of approximately $100x, and that distribution would have the economic effect of reducing the remaining value of the foreign corporation's common stock to zero. Nonetheless, because the distribution to the partnership is subject to the bank debt, the parties take the position, pursuant to section 301 (b)(2) of the Internal Revenue Code, that the amount of the distribution is zero for purposes of section 301. On that theory, no part of the distribution is treated either as a dividend or as a reduction of stock basis under section 301(c).
>
> The partnership is treated as having subsequently disposed of the stock of the foreign corporation, giving rise to a tax loss equal to the excess of the partnership's original basis in the

stock ($100x in the example) over the fair market value of the common stock alter the distribution of securities (zero). The deemed disposition of the stock may be based upon an election under section 301.7701-3(c) of the regulations to change the federal income tax classification of the foreign corporation from a corporation to a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under section 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Thereafter, typically in a later taxable year, the bank debt is repaid out of other assets held by the foreign corporation. Although the parties previously treated the debt as reducing the amount of the earlier distribution from the foreign corporation, promoters advise taxpayers to take the position that the foreign corporation's repayment of the debt is not treated as a distribution on its common stock.

- The PricewaterhouseCoopers description of the BOSS product was published at 1999 TNT 233-58 (12/6/99).

6. **ABA Tax Section recommendation to amend Circular 230** to provide new minimum standards for practitioners who provide "more likely than not" opinions used in the offering materials for corporate tax shelters (11/1/99). The recommended language would require the practitioner "to evaluate and take account of all relevant facts; to relate the applicable law to those facts; to consider, to the extent relevant and appropriate, both the substance and the purpose of the plan or arrangement; to identify and discuss all material tax issues; to identify and discuss the relevance and persuasiveness of the legal authority pertinent to the facts and material tax issues; and to contain a reasoned analysis of whether applicable authority supports the position taken by the taxpayer." The recommendation further provides that "it would be unreasonable for a practitioner merely to assume the existence of a business purpose for a transaction if business purpose is a material fact."

7. **Corporate tax shelter disclosure and registration requirements.** Ann. 2000-12, 2000-12 I.R.B. 835 Announcement of three sets of temporary and proposed regulations relating to disclosure and registration requirements for corporate tax shelters, as well as a notice of listed transactions.

a. **Lists.** T.D. 8875, Requirements To Maintain List of Investors in Potentially Abusive Tax Shelters, 2000-11 I.R.B. 761, and REG-103736-00, 2000-11 I.R.B. 768 (65 F.R. 11211, 3/2/00), modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909 (8/16/00) (modifications effective 8/11/00). Temporary and proposed regulations under §6112 amends Temp. Reg. 301-6112-1T, [in Q&A form] to require promoters to maintain a list of investors in "potentially abusive tax shelters." It relies on the Temp. Reg. §301.6111-2T definitions.

- Under the August 2000 amendments, only promoters that are classified as organizers under section 6111(e)(1) are required to register tax shelters.
- The August 2000 amendments to Reg. §301.6111-2T limit the definition of a tax shelter promoter to persons who participate in the organization, management or sale of a tax shelter under §6111(e)(1) and Reg. § 301.6111-1T (Q&A-26 through Q&A-33), or are related to such person under §§267 or 707(b).
- Under the August 2000 amendments, an organizer or seller of an interest in a shelter is not required to (but may) list any investor in a tax shelter that (1) is not required to be registered under §6111, (2) is not a listed transaction described in Reg. §301.6111-2T(b)(2), and (3) is not a projected income investment described in Reg. §301.6111-1T A-57A, *if* (a) the total consideration paid to all organizers and sellers with respect to such investor's acquisition of the interest is less than $ 25,000, or (2) the organizer reasonably believes that (A) such investor's acquisition of the interest will not result in a reduction of tax liability of any corporation (or corporations) that exceeds (i) $1 million in any single taxable year or (ii) a total of $2 million for any combination of taxable years and (B) will not result in a reduction of the income tax liability of any noncorporate taxpayer (or taxpayers) that exceeds (i) $250,000 in any single taxable year or (ii) a total of $ 500,000 for any combination of taxable years.

b. **Registration.** T.D. 8876, Corporate Tax Shelter Registration, 2000-11 I.R.B. 753 and REG-110311-98, 2000-11 I.R.B. 767 [65 F.R. 11215] (3/2/00). Temporary and proposed regulations under §6111(d) on registration of "confidential corporate tax shelters". Modified by T.D. 8896, Modification of Tax Shelter Rules, 65 F.R. 49909 (8/16/2000), effective 8/11/2000.

- Temp. Reg. §301.6111-2T defines these as "any transaction" [including "all the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement"]: (i) a significant purpose of which is the avoidance or evasion of Federal income tax; (ii) that is offered to any potential participant under conditions of confidentiality; and (iii) for which the tax shelter promoters may receive aggregate fees in excess of $100,000. Registration is to be on Form 8264, "Application for Registration of a Tax Shelter."
- Avoidance or evasion transactions include (1) "listed transactions" [see, e.g., Notice 2000-15]; (2) transactions lacking economic substance if the expected pre-tax profit (after foreign taxes and transaction costs) is insignificant relative to the present value of the expected net Federal income tax savings; or (3) if the transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and the promoter expects it to be presented in substantially similar form to more than one potential participant (unless the participant is expected to participate in the ordinary course of its business in a form consistent with customary commercial practice and there is a "long-standing and generally accepted understanding" that the Federal income tax benefits are allowable).
- Registration will not be required for "excepted transactions," which are those for which "there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits," or those transactions which the IRS has determined are not subject to registration requirements. A ruling request procedure is provided for.
- "Conditions of confidentiality" is a facts and circumstances determination, with an exception for written agreements expressly authorizing disclosure. Under the Aug. 2000 modifications, restrictions on disclosure of the structure or tax aspects of the transaction reasonably necessary to comply with securities laws are not considered to be a confidentiality agreement.
- Under the August, 2000 modifications, an exclusivity agreement (i.e., an agreement requiring the offeree to pay a fee to a promoter if the offeree engages in the transaction, whether or not the offeree uses the promoter's services) is a condition of confidentiality. But an exclusivity arrangement ordinarily will not result in an offer being treated as made under conditions of confidentiality if the provides express written authorization for disclosure. Limitations on disclosure or use constitute a condition of confidentiality only if the limitations relate to the structure or tax aspects of the transaction and the limitations are for the benefit of any person other than theofferee.
- Registration is to be made not later than the day on which the first offering for sale is made, with extensions generally until 8/26/00.

c. **Red Flagging Returns.** T.D. 8877, Tax Shelter Disclosure Statements, 2000-11 I.R.B. 747 and REG-103735-00, 2000-11 I.R.B. 770 (65 F.R. 11205, 3/2/00). Temporary and proposed regulations under §6011 requiring corporations to attach statements to their Federal corporate income tax returns that disclose tax shelters. Modified by T.D. 8896, Modification of Tax Shelter Rules, (65 F.R. 49909, 8/16/00), effective 8/11/00.

- Temp. Reg. §1.6011-4T was issued under §§6001 [required records provision] and 6011(a) [general requirement of return or statement]. It requires that, for "reportable transactions," corporations must both attach a disclosure statement to their tax returns [separately mailing a copy to the IRS Large & Mid-Size Business Division] and retain all related documents until the expiration of the statute of limitations. Related documents include all marketing materials, all written analyses, all correspondence, etc. Under the Aug. 2000 modifications, the required records include all documents and other records related to a transaction subject to disclosure under the regulations that are material to an understanding of the facts of the transaction, the expected tax treatment of the transaction, or the corporation's decision to participate in the transaction.
- A "reportable transaction" is either: (1) a "listed transaction" [see, e.g., Notice 2000-15, 2000-12 I.R.B. 826], or (2) another reportable transaction if it possesses at least two of six of the following characteristics: (a) confidentiality; (b) protection against the possibility that intended tax benefits will not be sustained (including rescission rights, refund of fees, insurance protection, indemnities other than customary non-promoter indemnities); (c) promoter fees in excess of $100,000; (d) expected tax treatment expected to differ by more than $5 million from book treatment; (e) the participation of a tax indifferent person; and (f) the expected characterization for U.S. income tax purposes differs from that for foreign taxes.

• Four exceptions are provided: (1) Transactions in the ordinary course of business in a form consistent with customary commercial practice if the taxpayer "reasonably determines" that it would have participated irrespective of the expected Federal income tax benefits; (2) Transactions in [ordinary course and customary commercial practice] if the taxpayer "reasonably determines" that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits are allowable for substantially similar transactions; (3) Transactions for which the taxpayer "reasonably determines" that there is "no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits"; (4) Transactions identified in published guidance as being exempt from disclosure.

d. Identified "tax avoidance transactions." Notice 2000-15, 2000-12 I.R.B. 826 (3/20/00). IRS list of tax transactions that IRS has determined to be tax avoidance transactions. Ten transactions are on the list, including "lease strips," certain Notice 98-5 transactions, *ACM*-type transactions, certain charitable remainder trust distributions, lease-in / lease-out transactions, Notice 99-59 encumbered property distributions, fast-pay stock arrangements, and Rev. Rul. 2000-12, 2000-11 I.R.B. 774, debt straddle transactions.

8. Rev. Rul. 2000-12, 2000-11 I.R.B. Loss on sale of debt straddle tax shelter [also called a "bull-bear bond" transaction] cannot be claimed. The shelter involves the taxpayer corporation purchasing two private placement debt instruments structured using reset provisions that will cause the value of the notes to move in opposite directions.

9. *Baby BOSS is a fraud too! Notice 2000-44 (8/11/00). "Artificial" capital losses generated by baby BOSS transactions will not be allowed.

• Scheme #1: The taxpayer purports to borrow at a premium interest rate. For example. a lender gives the taxpayer $ 3,000 and the parties treat the stated principal amount of the loan as only $ 2,000, with the remaining $ 1,000 that must be repaid representing interest. The taxpayer contributes the loan proceeds into a partnership, which assumes the liability, and uses the proceeds to purchase an investment asset worth $ 3,000. The taxpayer/partner takes the position under §§705(a)(2), 722, and 752(b) his basis in his partnership interest is $ 1,000 [the $3,000 cash contribution minus the $2,000 assumed liability], even though the value of the partnership interest is zero. The taxpayer then sells the partnership interest for a nominal amount, claiming a $ 1,000 capital loss. [Everyone apparently ignores the $1,000 discrepancy between the cash proceeds of the loan and the $2,000 "principal amount," which has to produce income to someone sometime.]

• Scheme #2: The taxpayer simultaneously purchases a call option and writes an offsetting call option, both of which are then contributed to a partnership. The taxpayer takes the position that the basis of the partnership interest equals the basis of the purchased call option, unreduced by the liability associated with the written call option, i.e., that the partnership did not assume a liability when it took responsibility for the written call option. The taxpayer then uses this artificially high basis to claim a capital loss on the sale of his partnership interest. [Compare Rev.Rul. 95-26, 1995-1 C.B. 131, holding that a partnership's short sale of securities creates a liability.]

• Notice 2000-44 disallows the losses [under §§165(a) and (c)] produced by both of these baby BOSS transactions as artificial, citing, in the case of individuals,*Fox v. Commissioner*, 82 T.C. 1001 (1984), holding that §165(c)(2) requires a primary profit motive for a loss from a particular transaction is to be deductible. T.C. Memo 1988- 570, in which the government won a summary judgment that commodities straddles were shams despite not having offered evidence of the taxpayers' offsetting gains. The notice also cites Reg. §1.702-2 [the partnership anti-abuse rules]. The government also is reexamining the partnership basis rules.

• **Compound indicia of criminal tax fraud?** The government believes that the Baby BOSS transactions were not being individually reported on schedule D, but instead have been buried in grantor trusts. For example, an individual taxpayer with an unrealized capital gain contributes both the appreciated assets and the baby BOSS partnership interest into a grantor trust, which sells both, and the individual reports only the net gain or loss from the grantor trust's transactions on his return, rather than breaking out gains and losses separately, as is required [by Reg. §1.671-2]. Treasury Department officials suggest that criminal penalties might apply to this kind of reporting, which willfully conceals the facts.

• **Changes coming to tax shelter disclosure rules.** The recently proposed corporate tax shelter disclosure rules will be changed by dropping of the requirement that a shelter be marketed to a corporation to trigger the requirement that a promoter maintain a customer list. Under the amended regulations, a customer list would have to be maintained for a shelter that is exclusively peddled to individuals, provided threshold amounts of fees and tax savings are met.

10. IRS Coordinated Issue Paper on Lease-Stripping Transactions, 7/21/00.

V. EMPLOYEE COMPENSATION AND PLANS

A. In General

1. REG-109101-98, proposed regulations under §411(d)(6), permitting qualified plants to eliminate some alternative forms of benefits (65 F.R. 16546, 3/29/00).

a. T.D. 8900, final regulations that permit qualified defined contribution plans to be amended to eliminate some alternative forms of benefit and to permit transfers between defined contribution plans that were not permitted under prior final regulations (65 F.R. 54100, 8/31/00).

2. T.D. 8880, final regulations under §401(a)(31) to provide specific rules that grant relief from disqualification to an eligible retirement plan that inadvertently accepts an invalid rollover contribution (65 F.R. 21312, 4/21/00). The regulations clarify that it is not necessary for a distributing plan to have a favorable IRS determination letter in order for a plan administrator of a receiving plan to reach a reasonable conclusion that a contribution is a valid rollover contribution.

3. T.D. 8878, Tax Treatment of Cafeteria Plans, 2000-15 I.R.B. 857 (2/23/00). Final Reg. §1.125-4 permitting mid-year cafeteria plan elections with respect to medical and group term life insurance by an employee who has a change of status, such as change in marital status or number of dependents, employment, work site, etc., during the year. [Employees generally are permitted to make elections between cash or qualified tax free benefits only at the beginning of the plan year.]

a. REG-117162-99, Notice of Proposed Rulemaking, Tax Treatment of Cafeteria Plans, 2000-15 I.R.B. 871 (2/23/00). Proposed amendments to various subsections of Regs. §§1.125-1, -2, and -4 would extend to dependent care assistance and adoption assistance the availability of mid-year cafeteria plan elections based on a change of status, under the same terms that apply to mid-year elections with respect to medical and group term life insurance under Reg. §1.125-4.

4. Same desk rule limited by Treasury, but it will take Congress to eliminate the rule completely. Rev. Rul. 2000-27, 2000-21 I.R.B. (5/5/00). Employer's sale of less than 85 percent of the assets in a trade or business does not constitute a sale of substantially all the assets within the meaning of §401(k)(10)(A)(ii), so the prohibition of distributions on the ground of separation from service under the "same-desk" rule will not be applied under those circumstances.

5. Notice 2000-32, 2000-26 I.R.B. (6/7/00). Provides permanent relief and guidance relating to the exception to the definition of "eligible rollover distribution" for hardship distributions. The exception was added in 1998 to §§402(c)(4) and 403(b)(8)(B).

6. Rev. Proc. 2000-27, 2000-26 I.R.B. (6/9/00). Opens the IRS determination process for individually designed pension plans for amendments incorporating legislative changes from 1994 to 1998. Extends remedial amendment period for one more year, i.e., to the last day of the first plan year beginning after 12/31/00. (The deadline for master and prototype plans is not extended beyond the 12/31/00 deadline set forth in Rev. Proc. 2000-20.)

7. T.D. 8891, final regulations relating to the increased cash-out limit, i.e., the increase from \$3,500 to \$5,000 of the limit on distributions from qualified retirement plans that can be made without participant or spousal consent (65 F.R. 44679, 7/19/00).

8. T.D. 8894, final regulations in Q&A form under §72(p) relating to plan loans (65 F.R. 46588, 7/31/00). These regulations are proposed to be modified by REG-116495-99, relating to suspended loan repayments during a participant's military service, to unrepaid loans treated as distributions, and to multiple plan loan arrangements (65 F.R. 46677, 7/31/00).

B. Individual Retirement Accounts

1. IRS limits reconversions: these involve a conversion from a traditional IRA to a Roth IRA, back to a traditional IRA, followed by "reconversion" to a Roth IRA. The limit is once in November/December 1998 and once in 1999. Notice 98-50, 1998-44 I.R.B. 10 (10/20/98). Interim rules, effective 1/1/98) as to successive "reconversions" from a traditional IRA, following an earlier conversion to a Roth IRA and a transfer back to a traditional IRA. Allows only one "reconversion" for November/December 1998 and one reconversion for 1999.

a. REG-115393-98, proposed regulations under §408A relating to the establishment of Roth IRAs (63 F.R. 46937, 9/3/98).

b. T.D. 8816, final regulations relating to §408A Roth IRAs (64 F.R. 5597, 2/4/99).

c. Announcement 99-5, 1999-3 I.R.B. 16 (12/23/98). Provides that reasonable alternative methods of reporting 1998 and 1999 recharacterizations of IRA contributions and 1998 and 1999 reconversions will be acceptable provided that the trustee provides appropriate instructions to the IRA owner on how to properly report the recharacterizations and reconversions for federal income tax purposes.

d. Announcement 99-106, 1999-45 I.R.B. 561 (10/27/99). Extends Ann. 99-5 to the 2000 year.

2. Was this Bunney dumb? Bunney v. Commissioner, 114 T.C. No. 17 (4/10/00). While he was married, the taxpayer established an IRA using community property. When he was divorced, the decree required him to pay over to former spouse one-half of the balance of the IRA. The one-half of community funds paid to the former spouse were not taxable to the former spouse on distribution of the funds to the husband followed by his transfer of them to the wife pursuant to the court judgment that ordered the funds "to be divided equally between the parties." The taxpayer-participant was taxed on the entire distribution. Judge Laro held that recognition of community property interests for federal income tax purposes would conflict with the application of §408, which defines an IRA as a trust created or organized "for the exclusive benefit of an individual or his beneficiaries." The court held, additionally, that the QDRO-like provisions of §408(d)(6) were inapplicable because there was no transfer of the IRA participant's "interest" in the IRA to his spouse.

3. Notice 2000-30, 2000-25 I.R.B. (6/2/00). Specifies a new consistent method to be used by IRA trustees for reporting IRA recharacterizations [trustee-to-trustee transfers] and reconversions [a conversion is the transfer, by rollover or other means, of an amount in a nonRoth IRA to a Roth IRA (which is treated as a distribution from the nonRoth IRA); a reconversion is a conversion from a nonRoth IRA to a Roth IRA of an amount that had previously been recharacterized as a contribution to the nonRoth IRA after having been earlier converted to a Roth IRA] occurring after 2000. Reporting of distributions on Form 1099-R, and reporting of contributions on Form 5498.

4. Notice 2000-39, 2000-30 I.R.B. 132 (7/11/00). Guidance permitting a new method for calculating the net income attributable to post-1999 IRA contributions that are distributed as a returned contribution or recharacterized as a contribution to a different-type IRA.

VI. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. T.D. 8874, final regulations under §513 clarifying when the travel and tour activities of tax-exempt organizations are substantially related to the purposes for which exemption was granted and provides needed guidance for tax- exempt organizations concerning when travel tour activities may be subject to tax as an unrelated trade or business (65 F.R. 5771, 2/7/00).

- The final regulations do not impose additional record-keeping requirements. However, examples in the final regulations illustrate that contemporaneous documentation showing how an organization develops, promotes and operates the travel tour, is relevant to the facts and circumstances analysis.

2. REG-209601-92, proposed regulations relating to the [unrelated business income] tax treatment of sponsorship payments received by exempt organizations (65 F.R. 11012, 3/1/00). The 1997 Act added Code §513(i), which provided that unrelated trade or business does not include the activity of soliciting and receiving qualified sponsorship payments. Being an "exclusive sponsor" is OK, but being an "exclusive provider" is not. Admission parties and pro-am playing spots are not OK. Advertising [e.g., the address and phone number of a sponsor that included the statement "For your music needs give them a call today at 555-1234"] on a noncommercial broadcasting station is not OK.

3. **All the charm and subtlety of John Rocker.** Branch Ministries v. Commissioner, 211 F.3d 137, 2000-1 U.S.T.C. ¶50,459 (D.C. Cir. 5/12/00). IRS did not abuse its discretion in revoking a church's tax-exempt status on the ground that the church took out an anti-Clinton ad a few days before the 1992 presidential election. Judge Buckley noted that the church could have created a related §501(c)(4) organization to do the same thing, but could not have used its tax-fee dollars for that purpose. An Equal Protection Clause argument on selective prosecution was rejected because "widespread and widely reported involvement by other churches in political campaigns" was held not comparable to placing advertisements in newspapers with nationwide circulation opposing a candidate and soliciting tax deductible contributions to defray the cost of the advertisements.

4. Quality Auditing Co. v. Commissioner, 114 T.C. No. 31 (6/19/00). Nonprofit corporation organized to audit structural steel fabricators pursuant to a quality certification program administered by the [§501(c)(6)] American Institute of Steel Construction is not a §501(c)(3) organization because it does not lessen the burdens of government nor confer benefits to the general public, but furthers the private interests of the steel fabricators. Judge Nims held that "the presence of a single nonexempt purpose, if substantial in nature, precludes exempt status, regardless of the number or importance of truly exempt purposes."

5. Private Letter Ruling 200037053 (6/22/00). The IRS issued a private letter ruling that concluded that contributions to a donor advised fund qualified as "public support" under §509(a)(1) to help the charity attain public charity status and to avoid private foundation status. The ruling was not issued to a community foundation but to a charity whose principal charitable purpose is to maintain a comprehensive web site where visitors can obtain information about charitable organizations.

B. Charitable Giving

1. ***The IRS goes after charitable split-dollar life insurance arrangements with all guns blazing.** Notice 99-36, 1999-26 I.R.B. 3 (6/28/99). The IRS "advises" taxpayers and §170(c) organizations (including §501(c)(3) charities) that certain charitable split-dollar insurance transactions that purport to produce charitable contribution deductions under §§170 or 2522 will not produce the tax benefits advertised by their promoters and may lead to penalties. The targeted transactions generally involve transfers of funds to a charity, with the understanding that the charity will use the funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer's family. In a related transaction, the charity enters into a split-dollar agreement (usually with a trust) that specifies the portion of the insurance policy premiums to be paid by parties related to the donor and the portion to be paid by the charity and the extent to which each party can exercise standard policyholder rights. Commonly the noncharitable beneficiaries enjoy disproportionately high percentages of the cash-surrender value and death benefits relative to the percentage of premiums paid. Although there is no express obligation that the taxpayer will transfer funds to the charity to cover premium payments, or requiring the charity to use funds transferred by the taxpayer for that purpose, both parties understand that this will occur.

a. **This result was codified by the enactment of I.R.C. §170(f)(10) in the Tax Relief Extension Act of 1999.** The legislative history explains that Congress was concerned about an abusive scheme referred to as charitable split-dollar life insurance, and the provision is designed to stop "the spread of this scheme," and goes on to state that "the provision restates present law." Section 170(f)(10) expressly denies a charitable contribution deduction for any transfer to a charity if (1) either (a) the charity directly or indirectly pays or paid any premium on a life insurance, annuity or endowment contract in connection with the transfer or (b) there is an understanding or expectation that any person will directly or indirectly pay any premium on any such contract, and (2) any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family (broadly defined in

§170(f)(10)(H) to include all lineal descendants of the taxpayer's or the taxpayer's spouse's grandparents and the spouses of all such descendants), or any other person (other than another charitable organization) chosen by the transferor. Section 170(f)(10)(D) provides an exception in certain cases in which a charitable organization purchases an annuity contract to fund an obligation to pay a charitable gift annuity. Section 170(f)(10)(E) provides an exception for transfers to certain charitable remainder trusts that posses all of the incidents of ownership of the contracts in question and are entitled to receive all payments under the contracts. Congress capped off its attack on these abusive schemes by imposing a punitive excise tax on the charities that participated in them; §170(f)(10)(F) imposes on a charitable organization an excise tax equal to 100 percent of the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is disallowed under §170(f)(10)(A). This excise tax applies *regardless of when the transfer to the charitable organization was made.*

b. Notice 2000-24, 2000-17 I.R.B. 952 (4/24/2000). This notice provides guidance to help charitable organizations comply with the information reporting requirements imposed in connection with §170(f)(10). The reporting requirements apply to charitable organizations that pay premiums after February 8, 1999, in connection with subject split-dollar life insurance, annuity, and endowment contracts.

2. ***Abusive charitable remainder trusts curtailed.** REG-116125-99, proposed regulations under §§643 and 664 to combat abuses in the use of charitable remainder trusts that occur when distributions in excess of income are made to non-charitable beneficiaries where the trustee borrows money or enters into a forward sale of the trust assets (64 F.R. 56718, 10/21/99). The trust would be treated as having sold a pro rata portion of its assets to the extent that the distribution (1) is not characterized as income under §664(b), and (2) is made from amount received by the trust that is neither (a) a return of basis nor (b) attributable to a deductible charitable contribution made in cash.

3. ***Shades of *Pasqualini*;[3] here taxpayers prevail because they did not plan to get any tax benefit from their purchase of used hospital equipment for $40,000 and their subsequent donation of the same equipment, by then valued at more than $1,000,000, to a new hospital.** Herman v. United States, 73 F. Supp. 2d 912, 99-2 U.S.T.C. ¶50,899 (E.D. Tenn. 9/28/99). Taxpayers' motivation for the purchase of the equipment from the bankrupt town hospital for $40,000 was to ensure that the equipment was available to the new town hospital when it reopened. Judge Hull granted taxpayers summary judgment, noting that the only issue was one of valuation, and crediting the appraisal performed even though not in strict compliance with the §170(a)(1) substantiation requirements [appraisal was not strictly a "qualified appraisal"]. Penalties sought were denied.

4. **Ghoul trusts rejected.** REG-100291-00, Notice of Proposed Rulemaking, Lifetime Lead Trusts, 2000-16 I.R.B. 917 (4/4/00). Proposed amendments to Reg. §25.2522(c)-3, relating to the definitions of a guaranteed annuity interest and a unitrust interest for purposes of the income, gift, and estate tax charitable deductions. The proposed regulation restrict the permissible terms for charitable lead trusts in order to eliminate the potential for abuse [e.g., artificially inflating the charitable deduction by using as a measuring life the life of an unrelated individual who is seriously ill but not "terminally ill" under the §7520 regulations; thus the charitable interest is valued based on the actuarial tables. The proposed regulations limit the permissible term for guaranteed annuity interests and unitrust interests to either (1) a specified term of years, or (2) the life of one or more of the following individuals living at the date of the transfer: (a) the donor, (b) the donor's spouse, or (c) a lineal ancestor of all the remainder beneficiaries. The limitation on permissible measuring lives does not apply to a charitable guaranteed annuity interest or unitrust interest payable under a charitable remainder trust described in §664. An interest for a specified term of years can qualify even if subject to a "savings clause" intended to ensure compliance with a rule against perpetuities, as long as the savings clause uses a period for vesting of 21

[3] **Purchaser of property held for contribution was not a dealer.** Pasqualini v. Commissioner, 103 T.C. 1 (7/18/94). Taxpayers purchased 180,000 Christmas cards for $30,000 at a U.S. Customs Service auction, held the cards for slightly more than one year, donated them in bulk to a charity, and claimed a §170 charitable contribution deduction for their $1,890,000 import duty valuation. **The Tax Court did reduce the value of the Christmas cards to $67,500,** Pasqualini v. Commissioner, T.C. Memo. 1994-323 (7/18/94). The court stated, "[taxpayers] should have known that deducting 63 times the cost of the cards was too good to be true." Valuation overstatement and §6621(c) additional interest penalties were also imposed.

years after the deaths of measuring lives who are selected to maximize, rather than limit, the term of the trust. When finalized the rules will be effective as of April 4, 2000.

5. **Is the cost of religious instruction in day schools deductible?** Field Service Advice 2000-1 (7/11/97). Tuition payments to Jewish day schools were not deductible as charitable contributions to the extent [55 percent] that their children's education consisted of religious instruction. The Service followed *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (substantial benefit received in return for payments), and no mention was made of the 1993 Church of Scientology settlement nor of §170(f)(8). In the 1993 closing agreement the IRS agreed "not to contest the deductibility of Church of Scientology fixed donations in connection with qualified religious services."

a. ***Taxpayers should have sued IRS officials like the Scientologists did.** Sklar v. Commissioner, T.C. Memo. 2000-118 (4/5/00). The court relied on *Hernandez* and found that the Church of Scientology settlement was irrelevant because the "auditing" involved there was "not identical [to the general, including religious, education involved in the case at hand] in their organization, structure or purpose."

VII. INTEREST

A. In General

1. Rev. Proc. 99-43, 1999-47 I.R.B. (11/9/99). The Service has issued modified guidance regarding the application of §6621(d) with respect to interest accruing before 12/1/98.

a. Rev. Proc. 2000-26, 2000-24 IRB 1257 (6/12/00). Procedures for applying zero net interest rate under §6621(d) for interest accruing on or after Oct. 1, 1999.

2. Rev. Rul. 99-40, 1999-40 I.R.B. 443, *modifying and superseding* Rev. Rul. 84-58 and Rev. Rul. 88-98. When a taxpayer reports an overpayment on its income tax return, interest will be assessed on that portion of a subsequently determined deficiency for the overpayment return year that is less than or equal to the overpayment as of: (1) the date on which the Service refunds the overpayment without interest; or (2) the date on which the overpayment is applied to the succeeding year's estimated taxes; interest will be assessed on any remaining portion of the deficiency from the original due date of the tax for the overpayment return year.

3. **Boy the way Glenn Miller played.[4] These interest free loans were all in the family.** Rountree Cotton Co. v. Commissioner, 113 T.C. 422 (12/16/99). The taxpayer corporation had four related shareholders, none of whom owned more than approximately one-third of its stock. The corporation made interest-free loans to another corporation and to four partnerships in which one or more of its shareholders owned stock or partnership interests. Various children of the shareholders owned 50% and 70% respectively of two of the partnerships, and the father of individuals who collectively owned a majority of taxpayer's shares owned one-third of the stock in the borrower corporation and 20% or more of the interests in two of the borrower partnerships.

- The Tax Court (Judge Gerber) held that §7872 applies to indirect corporation-to-shareholder loans effected by loans from a corporation to other corporations or partnerships in which its shareholders own stock or partnership interests. That no one shareholder of the lender corporation holds a majority interest in the lender and also holds an interest in the borrower did not affect the applicability of §7872. This was exactly the type of situation that §7872 was intended to address. The taxpayer / lender corporation was taxable on the forgone interest attributed to the entire loan. The court did not reach the issue of the proper treatment of the shareholders. The court held that, although §7872(h)(1)(B) directs the IRS to promulgate regulations to assure that the positions of the lender and borrower with respect to a below market rate of interest loan are consistent, nothing requires that the Commissioner actually initiate correlative adjustments with respect to other parties to the loan in connection with a deficiency proceeding with respect to one of the parties.

4. T.D. 8886, final regulations under §7520 revising the actuarial tables to be used in valuing annuities, interests for life or terms of years, and remainder or reversionary interests (65 F.R.

[4] "Boy the way Glenn Miller played .... Guys like us we had it made"
sung by Archie Bunker. Theme song for All in the Family.

36908, 6/12/00). Applies to interests created after 4/30/00. The revision was necessary because §7520(c)(3) requires the tables to be revised not less frequently than once each 10 years.

5. Security State Bank v. Commissioner, 214 F.3d 1254, 85 A.F.T.R.2d 1986 (10th Cir. 6/7/00), *aff'g* 111 T.C. 210 (1998). Section §1281, imposing the OID rules on certain short term debt instruments, applies only to investment type debt instruments, not to undiscounted "loans" with stated interest that have been "made" in the ordinary course of a cash method lender's business.

6. **Equity kicker to lender creates OID.** Custom Chrome, Inc. v. Commissioner217 F.3d 1117, 2000-2 U.S.T.C. ¶50,566, 86 A.F.T.R.2d 5156 (9th Cir. 7/10/00), *aff'g in part and vacating and remanding in part* T.C. Memo 1998-317. Warrants to purchase stock granted by a corporate borrower to lender to provide additional compensation to lender for making a risky loan, resulted in the "price paid" by the lender for the borrower's note [under §1273(b)] being less than the stated principal amount of the note. Thus the obligation was an OID instrument . The warrants, even though not publicly traded, properly were valued at time of issuance, not exercise because §83 and Reg. §1.83-7 apply only to warrants issued in exchange for services. But the Tax Court erred in finding that because the warrants were "at the money" at the time of issuance and the lender carried them n its books at only $1,000 they had not value and thus disallowing the taxpayer any deduction for accrued OID [which the taxpayer first sought in the Tax Court proceeding]. Under any well established financial method for valuing options, the warrants had value. Remanded.

VIII. NONTAXABLE EXCHANGES

A. Section 1031

1. ***Depreciation for MACRS property acquired in a §1031 exchange of MACRS property, or acquired in replacement of involuntarily converted MACRS property to which §1033 applies.** Notice 2000-4, 2000-3 I.R.B. 313. To the extent the taxpayer's basis in the acquired MACRS property does not exceed the taxpayer's adjusted basis in the exchanged or involuntarily converted MACRS property, the acquired property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted property. Any additional basis in the acquired property is treated as newly purchased MACRS property. [This is the same method as provided for ACRS property in Prop. Reg. §1.168-5(f) (1984).] Effective for acquired MACRS property placed in service on or after January 3, 2000, in a like-kind exchange of MACRS property under §1031 or as a result of an involuntary conversion of MACRS property under §1033. For property acquired before January 3. 2000, taxpayers who treated the entire basis as new MACRS property may continue to do so, or may change accounting methods to conform.

2. TAM 200035005 (5/11/00). The exchange of FCC radio licenses for an FCC television license is a like kind exchange under §1031. The agent had contended that the exchange of FCC licenses also involves an exchange of all the station's radio or TC property [including programming content , advertising contracts, etc.], while the taxpayer argued that the underlying property to which the licenses relate is the tangible personal property consisting of transmitters, towers and antenna [described in the same Product Classes 3663 and 3441 as in the SIC Manual].

3. **Look ma, "I'm an EAT in a QEAA!" A safe harbor for reverse exchanges is created by the IRS.** Rev. Proc. 2000-37, 2000-40 I.R.B. 308 (9/15/00). The IRS provided safe-harbor guidance blessing §1031 treatment for reverse *Starker* exchanges, i.e., when the replacement property is received by an "exchange accommodation titleholder" ("EAT") before the taxpayer transfers the property to be disposed of in the exchange [a situation not covered in Reg. §1.1031(k)-1], if the required conditions have been met.

- An "exchange accommodation titleholder" may be, but need not be, a qualified intermediary [as defined in Reg. §1.1031(k)-1(g)(4)], but may not be a disqualified party [as defined in Reg. §1.1031(k)-1(k)] and must be either subject to tax or a partnership of S corporation more than 90 percent owned by persons subject to tax. Under the Rev. Proc. the exchange accommodation titleholder will be treated as the owner of the property if the property is held in a "Qualified Exchange Accommodation Arrangement." The EAT must hold legal or beneficial title to the property, i.e., "qualified indicia of ownership."

- The QEAA must be identified in writing within 5 days of the EAT acquiring qualified indicia of ownership, the relinquished property must be identified [consistently with the principles of Reg. §1.1031(k)-1(g)(4)] within 45 days of the exchange accommodation titleholder acquiring qualified indicia of ownership, and the exchange must be completed within 180 days of the intermediary acquiring qualified indicia of ownership.
- The taxpayer (or a disqualified party) can guarantee the accommodation party's debt, advance funds to the accommodation party to pay the purchase price, lease the property from the accommodation party, supervise the property or construction, and provide certain arrangements to protect the accommodation party against risk of loss from fluctuations in value.
- A transaction can qualify under both the Rev. Proc. and the regulations if the accommodation party is a qualified intermediary who holds both properties simultaneously for some period [not in excess of 180 days].
- No inference is to be drawn regarding the treatment of a transaction not covered by the safe harbor. Effective 9/15/00.

B. Section 1041

1. ***'Tis doubly blessed to get redeemed in divorce than in marital bliss.** Read v. Commissioner, 114 T.C. No. 2 (2/4/00). Mr. and Mrs. Read (H & W) owned substantially all of the stock of Mulberry Motor Parts, Inc. (MMP). When they divorced, the final judgment ordered (1) that W sell to H, or at H's election to MMP or MMP's ESOP plan, all of her MMP stock, and (2) that H, or at H's election MMP or MMP's ESOP plan, pay $838,724 to W ($200,000 down and the balance by interest bearing note). H elected to cause MMP to purchase and pay for W's stock, and the transaction was so structured. W argued that she was entitled to nonrecognition under §1041(a) and Reg. §1.1041-1T(c), Q & A-9, which treats certain transfers to third parties as a transfer of property by the transferring spouse directly to the nontransferring spouse that qualifies for nonrecognition treatment under §1041 followed by an immediate transfer of the property by the nontransferring spouse to the third party in a transaction that is not subject to §1041 – i.e., H would have a redemption treated as a dividend. H argued that §1041(a) and Reg. §1.1041-1T(c), Q&A-9 were inapplicable because he never had an unconditional obligation to purchase W's MMP stock, and that accordingly he recognized no income and W recognized gain on the redemption of her stock . The Commissioner took the position that he was a mere stakeholder and had issued deficiency notices to both taxpayers in the joined cases to avoid a whipsaw, but the Commissioner argued that W "has the better argument."

- The Tax Court in a reviewed opinion (8-7) by Judge Chiechi, agreed with the Commissioner and W. The court held that in cases involving corporate redemptions in a divorce setting, the primary-and-unconditional-obligation standard that generally applies in "bootstrap-acquisitions" [see Rev. Rul. 69-608, 1969-2 C.B. 42] is not the appropriate standard to apply to determine whether the transfer of property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Reg. §1.1041-1T(c), Q&A-9. Applying the common, ordinary meaning of the phrase "on behalf of" in Q&A-9, W's transfer of her stock to MMP was a transfer of property by W to a third party on behalf of H within the meaning of the regulation. Thus, under §1041(a), no gain was recognized by W and H recognized a dividend. The majority reasoned that *Hayes v. Commissioner*, 101 T.C. 593 (1993), did not limit the treatment of a redemption of one divorcing spouse's stock as a §1041 transfer by that spouse and a dividend to the nonredeeming spouse. It distinguished *Blatt v. Commissioner*, 102 T.C. 77 (1994), because in that case the record did not establish that corporation acted on behalf of husband in redeeming wife's stock; and the majority attempted to distinguish the Tax Court's prior opinion in *Arnes v. Commissioner*, 102 T.C. 522 (1994), as involving an instance in which the husband did not have an unconditional obligation to acquire the wife's stock.

- Dissents by Judges Ruwe, Halpern, and Beghe, all argued in one way or another that the primary-and-unconditional-obligation standard that generally applies in bootstrap-acquisitions was the appropriate standard to apply, nothing in Reg. §1.1041-1T(c), Q&A 9 indicated otherwise, and that on the facts H did not have a primary and unconditional obligation to purchase W's stock.

- A joint dissent by Judges Laro and Marvel argued that Reg. §1.1041-1T(c), Q&A 9, never should apply to redemptions like those in any of these cases.

2. ***The wrong answer again, via Judge Hall of the Ninth Circuit, who here defers to the Tax Court – as has been so seldom her wont. Remember, it all began with the Ninth Circuit's Arnes decision that gave the temporary(?) regulations under §1041 such a convoluted interpretation.**[5] Craven v. United States, 2000-2 U.S.T.C. ¶50,541, 85 A.F.T.R.2d 2229 (11th Cir. 6/19/00). Stock redemption incident to 1989 divorce for $4.8 million in future cash is governed by §1041, so the redeeming spouse does not recognize gain nor (because §1041 applies) does she have imputed interest during the period before receiving cash. The stock redemption agreement between the redeeming spouse and the corporation provided that the payments to be made were without stated interest, and that the corporation would send her Forms 1099-INT stating the amounts of interest imputed to her under §1272. Senior Judge Cynthia Hall (of the 9th Circuit) followed Read, *infra*, to find the redemption was governed by §1041 pursuant to Temp. Reg. §1T, Q&A-9.

- It appears that the intention of the parties in 1989 was to have the redemption treated as a taxable redemption by the redeeming spouse, and to have the wife taxed on the gain. The stock redemption agreement provided that since the payments under the note were without stated interest the corporation would send the redeemed wife Forms 1099-INT stating the amounts of interest imputed to her under § 1272, which the corporation did. The parties did not contemplate a §1041 transfer because under Reg. §1.1274-1(b)(iii) the original issue discount rules do not apply to transactions covered by §1041.

a. **The nuances of §§301 and 302 elude yet another court when §1041 is pulled over the judge's eyes.** Craven v. United States, 70 F. Supp. 2d 1323, 99-1 U.S.T.C. ¶50,336, 83 A.F.T.R.2d 1268 (N.D. Ga. 2/18/99). The court followed the Ninth Circuit's decision in *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992), to apply §1041 to provide nonrecognition on redemption pursuant to divorce decree of wife's 47 percent of stock of a corporation controlled by husband. The court reasoned that the purpose of the redemption was to effect a division of marital property and thus §1041 applied to the wife. The opinion states that the proper treatment of the husband, i.e., whether the husband had a constructive dividend by reason of the redemption, was not before the court and, in any event, was not

[5] **Ninth Circuit applies §1041 to exclude gain on wife's stock redemption.** Arnes v. United States, 981 F.2d 456, 93-1 U.S.T.C. ¶50,016 (9th Cir. 12/11/92). Affirms district court's grant of summary judgment to taxpayer, holding that the divorce-settlement redemption of taxpayer's stock (in a McDonald's franchise corporation she owned equally with her former husband) qualified for exemption under §1041. The former husband was held to have been relieved of an obligation by the corporate redemption, so A-9 of Temp. Reg. §1.1041-1T would treat taxpayer's stock as having been transferred to her former husband, and then retransferred to the corporation (the "third party") in a non-§1041 transaction. The $450,000 cash is to be treated as paid to taxpayer by the corporation on behalf of her former husband (and presumably constituting a taxable distribution to her former husband). See Temp. Reg. §1.1041-1T, A-2, Example (3).

But Tax Court holds §1041 does not apply to tax her husband on the redemption, so neither is taxed. Arnes v. Commissioner, 102 T.C. 822 (4/5/94) (reviewed, 7 judges dissenting). Redemption of wife's stock [in corporation owned 50-50 by husband and wife] was not a constrictive dividend to husband because he did not have a primary and unconditional obligation to purchase wife's stock, relying on Rev. Rul 69-608, 1969-2 C.B. 42. Dissents on ground that the Ninth Circuit has passed on the legal issue, citing Golsen v. Commissioner, 54 T.C. 742 (1970) aff'd, 455 F.2d 985, 71-2 U.S.T.C. ¶9497 (10th Cir. 1971), and on the untenable result that neither stockholder will incur tax consequences as a result of the $450,000 stock redemption.

Tax Court had held for wife when husband had been obligated to purchase her stock. Hayes v. Commissioner, 101 T.C. 593 (12/29/93). The existence of a provision in their separation agreement obligating husband to purchase wife's stock in their wholly-owned [McDonald's franchise] corporation results in a constructive dividend to husband when the corporation redeemed wife's shares and results in tax-free §1041 treatment to wife under Temp. Reg. §1041-1T(c), Q & A 9.

The Tax Court disagrees with the Ninth Circuit's Arnes case, and Judge Beghe has the correct answer. Blatt v. Commissioner, 102 T.C. 77 (1/31/94) (reviewed, 3 judges dissenting). Wife's redemption (pursuant to a divorce decree) of all her stock in a corporation she owned entirely with her husband was not governed by §1041, and was taxable to her. The court refused to follow the Reg. §1.1041-1T, Q&A 9 theory that the redemption was a transfer to the corporation on behalf of her husband, as held in *Arnes v. United States*, 93-1 U.S.T.C ¶50,016 (9th Cir. 1993), which the court refused to follow. Judge Beghe's concurring opinion stated that the proper interpretation of that regulation should be that no redemption should be considered to be "on behalf of" the remaining spouse unless it discharges that spouse's primary and unconditional obligation to purchase the redeemed stock, as set forth in the examples of Rev. Rul. 69-608, 1969-1 C.B. 42.

relevant to the proper treatment of the wife's redemption. The court did get right that §1041 did apply to the OID component of the promissory note that the wife received in exchange for the redeemed stock.

3. Another "income item" exception to §1041? The IRS concludes that *United States v. Davis*, 370 U.S. 65 (1962), is still alive when it comes to transactions not involving property and that this is just an assignment of (compensation) income. Field Service Advice 200005006 (11/1/99). When an ex-husband transfers stock options to his ex-wife incident to a divorce, he has §83 ordinary income on their FMV at that time, and she gets a carryover basis under §1041(b). (If the options originally were incentive options, they automatically become nonqualified upon transfer.) Neither spouse will be taxed when the options are exercised, but she will recognize capital gain on the sale of the stock. Her basis is the sum of her carryover basis and the exercise price. The FSA analogizes the result from the transfer of savings bonds with accrued interest. Rev. Rul. 87-112, 1987-2 C.B. 207.

- When ex-wife later exercised the options, employer issued a Form 1099 to the ex-husband. He included the gain on his tax return and filed a refund claim. Under *United States v. Davis*, 370 U.S. 65 (1962), the stock options were exchanged for the release of other marital rights or property. Therefore, the transfer was at arm's length and subject to the §83 rule that stock options are taxable on transfer. When the ex-wife exercised the options, it was not a taxable event. Instead, the Service said, when the stock received is sold she will realize gain on the difference between the stock's selling price and her basis, which is the sum of her carryover basis from the husband's taxable transfer and the exercise price.

- Anticipating an argument that §1041 shields the husband from tax, the Service remarked that the options were compensation. §1041 only deals with the nonrecognition of gain or loss in an interspousal transfer, not with excluding income. The Service also noted that the assignment of income doctrine overrides §1041.

- The FSA reasons that under *United States v. Davis*, which was overruled with respect to transfers of property by the enactment of §1041, the stock options were exchanged for the release of other marital rights or property; thus they were an income item, not "property," so the transfer was taxable to the husband.

- The are two internal inconsistencies in the reasoning of the FSA: (1) Under pre- §1041 law, the transferee spouse took a FMV basis, not a carryover basis. Rev. Rul. 67-221, 1967-2 C.B. 63. (2) Under *Berger v. Commissioner*, T.C. Memo 1996-076, under the §1041 regime, if the transferor spouse recognizes gain on the transfer of an income item, the transferee spouse is entitled to a stepped-up basis.

C. Section 1042

1. Rev. Rul. 2000-18, 2000-14 I.R.B. 847 (4/03/00). If a taxpayer who has sold stock to an ESOP or cooperative and has elected to defer the recognition of gain under §1042(a) subsequently transfers qualified replacement property to a partnership in exchange for a partnership interest, the transfer to the partnership is a disposition of the qualified replacement property resulting in recapture of the deferred gain under §1042(e).

IX. PARTNERSHIPS

A. Partnership Audit Rules

1. GAF Corp. v. Commissioner, 114 T.C. No. 33 (6/29/00) (reviewed, 10-3). The question was whether the transfer of property to the partnership was to be treated as a sale or as a contribution to capital – an $80 million question. The IRS issued a both statutory notice to GAF and an FPAA to the partnership. Judge Ruwe, for the majority, decided that a deficiency notice based on "affected items" issued prior to completion of the related partnership-level proceedings is invalid, so the Tax Court proceeding based on the deficiency notice must be dismissed for lack of jurisdiction.

- Judge Halpern, in dissent, would overrule the Maxwell v. Commissioner, 87 T.C. 783 (1986), line of cases to the extent they hold the Tax Court lacks subject matter jurisdiction to redetermine a deficiency attributable until the related partnership proceeding is completed. The minority would not dismiss, but only defer proceeding until consideration of the affected items is appropriate.

• The related case of Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. No. 34 (6/29/00) (reviewed, 8-6), dealt with a partner's motion for summary judgment based upon the running of the statute of limitations, which was denied. The majority did not see dismissal of the partner-level case as mooting the partnership-level case.

B. Miscellaneous

1. **Modifies check-the-box rules, so that Treasury may put all those refund checks back in the storage box.** T.D. 8844 and REG-1 10385-99, final and proposed regulations describing how elective changes in classification will be treated for federal tax purposes [final regulations] and prescribing anti-abuse rules that apply to "extraordinary transactions" that occur within one year before or after a change in entity classification [proposed regulations] (64 F.R. *66580* & 66591, 11/29/99).

2. Kerr v. Commissioner, 113 T.C. 449 (12/23/99). Although taxpayers transferred limited partnership interests – and not assignee interests—they were still entitled to apply liquidity discounts in valuing those interests. Judge Jacobs held that §2704(b) did not apply because – based upon Reg. §25.2704-2(b), the dissolution and liquidation provision contained in the partnership agreements was no more restrictive than the limitations that would apply generally to partnerships under Texas law.

3. **Was it just a Court Holding Co. problem, or is the problem something bigger?** Twenty Mile Joint Venture v. Commissioner, 200 F.3d 1268, 2000-1 U.S.T.C. ¶50,124, 84 A.F.T.R.2d 7645 (10th Cir. 12/27/99), *aff'g* Parker Properties Joint Venture v. Commissioner, T.C. Memo. 1996-283,. Two real estate partnerships, Twenty Mile Joint Venture and Parker Properties Joint Venture [in which two of the partners were names Winn and Gitliz; does that ring a bell?], owed approximately $16,000,000 to lender, an affiliate of which was a 50 percent partner. When the lender's parent became insolvent and was taken-over by another bank, the new creditor proposed to sell its worthless equity interests in the partnerships back to the partnerships for $ 5,000 each and to accept approximately $4.8 million less that the outstanding balance in satisfaction of the loans. At the partnerships' request, at the last minute, the transaction documentation was restructured to provide that the lender contributed $4.8 million to the partnerships, in the form of loan reduction, rather than a simple cancellation of indebtedness, while nevertheless simultaneously selling its equity interests in both partnerships to the Parker Properties partnership for $10,000. The partnerships' argued that the forgiven $4.8 million was converted to equity before the sale and that no COD income resulted. This was a tough row to hoe because the lender reported the $4.8 million as an ordinary loss from loan forgiveness and filed information returns showing it as COD income to the partnerships. [On audit, the lender agreed to treat the affiliate's percent share of debt as COD income.]

• Tax Court (Judge Gerber) held that the substance of the transaction was COD, without any contribution to partnership capital, dismissing the partnership's arguments that the bank's relief from any further liabilities associated with the properties was significant.

• The Court of Appeals affirmed, rejecting, on "substance over form" grounds, the argument that the reduction of the partnerships' debt to the bank was a capital contribution. The court found no proof that the bank received anything in exchange for the purported contribution to capital, in the form of relief from other liabilities or otherwise. The purported contribution to capital of the difference between what the partnerships owed and what the bank was willing to accept was really COD.

4. ***The eternal question: Is a partnership an entity or is it an aggregate?** Rev. Rul. 99-57, 1999-51 I.R.B. 678 (12/20/99). This ruling explains the tax consequences to a partnership and a corporate partner where the corporate partner contributes its own stock to the partnership, and the partnership later exchanges the stock with a third party in a taxable transaction.

• No gain or loss is recognized to the corporate partner or the partner [§721(a)], the partnership's basis in the stock is zero [§723], and the corporate partner's basis in its partnership interest is unchanged [§722]. When the partnership transfers the stock to a third party in exchange for property or services, the partnership realizes gain equal to the difference between the basis of the stock and the value of the property and services received. Any built-in gain is allocated to the contributing corporate partners under §704(c), and any remaining gain is allocated under §704(b). Pursuant to §1032, none of the corporate partner's share of gain is recognized [aggregate theory], but under §705 the corporate partner increases its basis in the partnership interest by the unrecognized gain [thereby preserving the nonrecognition result of the transaction in accordance with the policy underlying §1032]. The same principles apply if the corporate partner is allocated a loss from a transaction involving the disposition of its stock held by the partnership.

5. ***New optional inside basis adjustment rules made final.** T.D. 8847, 1999-51 I.R.B. 701 (64 F.R. 69903, 12/14/99). The new Regulations make final extensive changes in the computation of optional partnership inside basis adjustments under §§734(b), 743(b), and 755. The regulations relate to: (1) the optional adjustments to the basis of partnership property following §743 transfers of partnership interests; (2) the calculation of gain or loss under §751(a) following the sale or exchange of a partnership interest; (3) the allocation of basis adjustments among partnership interests under §755; (4) the allocation of a partner's basis in its partnership interest to properties distributed to the partner by the partnership under §732(c); and (5) the computation of a partner's proportionate share of the adjusted basis of depreciable property under §1017.

- The Regulations permit offsetting positive and negative adjustments to different classes of assets under §743(b), as well as adjustments under §734(b) that increase the difference between fair market value and basis, and provide detailed rules for post-adjustment depreciation.

- For an analysis of the new Regulations in their proposed form, see McMahon, "Optional Partnership Inside Basis Adjustments," 52 Tax Lawyer 35 (1998).

a. REG-209682-94. (63 F.R. 4408, 1/29/98). Proposed regulations relating to: (1) the optional adjustments to the basis of partnership property following §743 transfers of partnership interests; (2) the calculation of gain or loss under §751(a) following the sale or exchange of a partnership interest, (3) the allocation of basis adjustments among partnership interests under §755; (4) the allocation of a partner's basis in its partnership interest to properties distributed to the partner by the partnership under §732(c); and (5) the computation of a partner's proportionate share of the adjusted basis of depreciable property under §1017

- The Proposed Regulations would extensively alter the computation of optional partnership inside basis adjustments under §§734(b), 743(b), and 755. The Proposed Regulations permit offsetting positive and negative adjustments to different classes of assets under §743(b), as well as adjustments under §734(b) that increase the difference between fair market value and basis, and provide detailed rules for post-adjustment depreciation.

6. ***Partnership §179 passthrough is limited to the taxable income of the partnership.** Hayden v. Commissioner, 2000-1 U.S.T.C. ¶50,219, 85 A.F.T.R.2d 825 (7th Cir. 2/11/00), *aff'g* 112 T.C. 115 (3/19/99). The court upheld the validity of Reg. §1.179-2(c)(2), which limits the §179 deduction passed through to partners to the taxable income of the partnership. The result was dictated by §§179(b)(3)(A) and 179(d)(8) themselves.

7. **Notice of proposed rulemaking, allocation of partnership debt.** REG-103831, 99, 2000-5 I.R.B. 452 (1/12/00) Prop. Reg. §1.752-3(b) would solve problems that have arisen in determining how to determine the amount of §704(c) minimum gain under Reg. §1.752-3(a)(2) when a partnership holds multiple properties subject to a single nonrecourse liability. This problem typically occurs when a partnership that holds several properties subject to individual mortgages refinances the individual liabilities with a single nonrecourse mortgage. Under the proposed regulations a partnership that holds multiple properties subject to a single liability may allocate the liability among the properties using any reasonable method. A method is not reasonable if it allocates to any property an amount that exceeds the fair market value of the property. Thus, for example, the liability may be allocated to the properties based on the relative fair market value of each property. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate liability under Treas. Reg. §1.752-3(a)(2). Once a liability is allocated among the properties, a partnership may not change the method for allocating the liability. If, however, one of the properties ceases to be subject to the liability, the portion of the liability originally allocated to that property must be reallocated to the properties still subject to the liability.

8. **Notice of proposed rulemaking, applying section 197 to partnerships.** REG-100163-00, 2000-7 I.R.B. 633 (1/25/00). Prop. Reg. §1197-2(h)(12)(ii) regarding when the §197(f)(9)

anti-churning rules will be applied to basis increase for §197 amortizable intangibles under §732(b) or §734(b).

9. **Notice of proposed rulemaking, coordination of sections 755 and 1060 relating to allocation of basis among partnership assets.** REG-107872-99, 2000-16 I.R.B. 911 (65 F.R. 17829, 4/5/00). Proposed regulations relating to the allocation of basis adjustments among partnership assets under §755, which implement §1060(d) [which applies the residual method to partnership transactions in connection with determining the value of §197 intangibles].

- Prop. Reg. §1.755-2 [to replace Temp. Reg. §1.755-2T] implements §1060(d), by applying the residual basis allocation method to all allocations of §743(b) [and §734(d)] inside basis adjustments under §755. These proposed regulations determine the value of the partnership's individual assets, which value is in turn used to determine the allocation under Reg. §1.755-1 of the inside basis adjustment. Under the proposed regulations, the amount paid for the transferred partnership interest is the benchmark for valuing all of the partnership's assets. The partnership's assets are valued in five tiers: (1) cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions; (2) partnership assets other than cash equivalents, capital assets, §1231(b) property, and §197 intangibles (i.e., ordinary income property other than §1245 recapture and other items treated as unrealized receivables under the flush language of §751(c)); (3) capital assets and §1231(b) property other than §197 intangibles; (4) §197 intangibles other than goodwill and going concern value; (5) goodwill and going concern value.

10. Gulley v. Commissioner, T.C. Memo. 2000-190 (6/27/00). Even though under the relevant state law [Texas], a general partner of a limited partnership ceased to be a partner in a partnership upon the partner's bankruptcy, the bankruptcy of the sole general partner of a limited partnership did not terminate the partnership under §708(b)(1)(A) because the partnership did not wind up its affairs until a later year. The succession of the chapter 7 bankruptcy estate to the bankrupt partner's 66.67% partnership interest under §1398 was not a "transfer" resulting in a termination of the partnership under §708(b)(1)(B). The bankrupt partner's partnership year did not close under §706(c)(2)(A). Section 706(d) did not apply either. Thus, the passed-through partnership loss for the entire year was allocated to the bankruptcy estate.

11. Penny-wise and pound foolish. How to vaporize depreciation deductions. Jeyapalan v. Commissioner, T.C. Memo 2000-207 (7/5/00). The taxpayers formed a partnership to purchase and operate an apartment building. The acquisition was substantially debt financed. Subsequently, to obtain limited tort liability, the partners formed an S corporation and began conducting the rental activity through the corporation. Although title to the building never was transferred to the corporation [because the lender demanded a $10,000 fee to transfer the liability], the partnership filed a final tax return and the taxpayers held out the corporation as the owner and operator of the building. Only the taxpayer's cash contributions to the S corporation were taken into account in determining the basis limitation on passed-through losses under §1366(d), and most of the operating losses were disallowed at the shareholder level. [Note that if the partnership had been liquidated and the apartment transferred to the corporation, the shareholders' initial §358 basis in their stock would have indirectly included the amount of the purchase-money debt on the building].

X. PERSONAL AND INDIVIDUAL INCOME AND DEDUCTIONS

A. Deductions and Credits

1. **The individual AMT** originally was intended to apply primarily to taxpayers with significant economic income who because of tax shelter investments were paying little or no income taxes. Because of numerous amendments to the AMT and the regular income tax provisions over the years, mostly provisions specifically limiting tax-shelter deductions andcredits, the individual AMT currently does not significantly affect investors or businesses. Instead it increasingly affects middle-class wage earners – taxpayers not engaged in tax-shelter or deferral strategies. For 1997 five items that are "personal" in nature and not the result of tax planning strategies – personal exemptions, standard deductions, state and local tax deductions, medical expense deductions, and miscellaneous itemized deductions — collectively comprised 73.4 percent of individual AMT preferences and adjustments. Studies indicate that, by 2007, almost 95 percent of the revenue from AMT preferences and adjustments

will be derived from the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. See Harvey & Tempalski, *The Individual AMT: Why It Matters*, 50 Nat. Tax J. 468 (1997); *Tax Simplification Recommendations From ABA, AICPA, and TEI*, LEXIS, TAX ANA, 202000 TNT 39-82 (Feb. 28, 2000). Because the individual AMT so widely misses its original mark while adding inordinate complexity to the tax system for middle-class wage earners due to its interaction with limitations on the various personal credits, there is growing sentiment for its repeal, even among tax "reformers" who originally supported the enactment of the individual AMT.

a. ***The alternative minimum tax ("AMT") trap for attorneys' fees on large recoveries.** See Alexander v. IRS, 72 F.3d 938; 96-1 U.S. T.C. ¶50,011 (1st Cir. 1995), *aff'g* T.C. Memo 1995-51. Attorney's fees are miscellaneous itemized deductions, and may not be deducted for AMT purposes. The entire recovery of $250,000, of which $245,000 was retained by taxpayer's lawyer as legal fees, was required to be included in gross income. The attorney's fees were allowable only as a miscellaneous itemized deduction.

b. ***Attorney's fees not included in the income of taxpayer who received a large punitive damages award, at least in the Fifth and Eleventh Circuits (as derived from pre-split Fifth Circuit precedents), under the Golsen rule.** Davis v. Commissioner, T.C. Memo. 1998-248 (7/7/98). Willa Mae Davis recovered $152,000 of compensatory damages and $6 million of punitive damages against two companies that made loans to homeowners in Alabama. Her share of the recovery after legal fees and expenses was $3,039,191. Generally, the Tax Court holds that attorney's fee awards paid directly to a plaintiff's attorney [or the portion of a damage award that is the attorney's contingent fee that is so paid] are nevertheless includable in the litigant's gross income, and that the taxpayer then may claim a deduction, subject to any applicable limitations, including disallowance of the deduction for AMT purposes if it is a §212 deduction. *Bagley v. Commissioner*, 105 T.C. 396 (1995), aff'd 121 F.3d 393 (8th Cir. 1997). *Accord Baylin v. United States*, 43 F.3d. 1451 (Fed. Cir. 1995).

- In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), however, the Fifth Circuit held that attorney's fees so paid directly to a plaintiffs attorney are not includable by the litigant. In *Davis*, which was appealable to the Eleventh Circuit, the Tax Court followed *Cotnam* under the *Golsen* rule because under *Bonner v. City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981), Fifth Circuit decisions rendered before the Eleventh Circuit was created are binding precedent in the Eleventh Circuit.

c. **The Eleventh Circuit affirms *Davis*.** Davis v. Commissioner, 210 F.3d 1346, 2000-1 U.S.T.C. ¶50,431 (4/27/00) (per curiam). The Eleventh Circuit panel held that it was bound by *Cotnam*. The IRS argued in the alternative that taxpayer made a taxable disposition of her property in [time-barred] 1989, and that the *Burnet v. Logan* open transaction applied. The court held that *Burnet v. Logan* applies only when both the asset exchanged and the asset received have an unascertainable value, and "the IRS provided no proof that the values of either the cause of action or the attorneys' services were unascertainable."

d. **But, not so fast . . . Tax Court says case involving attorney's fees paid under Texas common law is not bound by *Cotnam*, which involved Alabama law which by statute gives attorneys a substantive right to fees based on their lien.** Srivastava v. Commissioner, T.C. Memo. 1998-362 (10/6/98). Taxpayers not entitled to excluded the 40 percent of their settlement proceeds from a personal injury lawsuit that they assigned to their attorneys. Under the Texas common law on attorneys' liens, no ownership interest was transferred to the attorneys. Judge Parr held that Cotnam v. Commissioner, *supra*, was inapplicable to this case under the Golsen rule because the Texas common law [giving no ownership rights to the attorneys] differed from the Alabama statutory law ["the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them."].

- The attorneys' fees are deductible for regular income tax only as a miscellaneous itemized deduction governed by §67, and not deductible at all for alternative minimum tax ("AMT") purposes.

- On the issue of allocating the settlement that was entered into after the damage award by the trial court, the Commissioner proposed a method of allocation, suggesting that "it is presumed that actual damages would be paid before prejudgment interest, postjudgment interest, or punitive damages, and that prejudgment interest would be paid before punitive damages."

• To the same effect under Arizona common law attorneys' liens is *Sinyard v. Commissioner*, T.C. Memo. 1998-364 (10/7/98) (Swift, J.).

e. ***Fifth Circuit: Texas statutory lien not subject to AMT trap. *Srivastava* reversed in split decision based upon *Cotnam*.** Srivastava v. Commissioner, 220 F.3d 353, 2000-2 U.S.T.C. ¶50,597 (5th Cir. 7/21/00) (2-1). As a matter of original impression, the majority (Judge Jerry Smith) would have included contingent fees in taxpayer's gross income under the anticipatory assignment of income doctrine, as are non-contingent attorney's fees includible in gross income. However, Judge Smith held that *Cotnam* cannot be distinguished because there is no difference in the "economic reality facing the taxpayer-plaintiff" between Alabama and Texas attorney's liens and any distinction between them does not affect the analysis required by the anticipatory assignment of income doctrine.

• Dissent by Judge Dennis distinguishing *Cotnam* on the ground that Alabama law gives the holders of attorney's liens greater power than does Texas law.

f. ***The Sixth Circuit creates a split in the circuits on the AMT trap for attorney's fees.** Estate of Clarks v. Commissioner, 202 F.3d 854, 2000-1 U.S.T.C. ¶50,158, 85 A.F.T.R.2d 405 (6th Cir. 1/13/00). The Sixth Circuit applied *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959) to hold that the taxpayer was not required to include the portion of the taxable interest attached to a damage award excluded under §104(a)(2) that was paid directly to the taxpayer's attorney. Although the Sixth Circuit discussed the particularities of the attorney's fee statutory lien law in *Cotnam*, found the Michigan attorney's fees common law lien law to be similar to the Alabama law involved in *Cotnam*. The court stated that it was following *Cotnam*, and went on to provide an arguably broader explanation for its decision, concluding that the opinions representing the weight of authority, e.g., *Baylin v. Commissioner*, 43 F.3d 1451 (Fed. Cir. 1995), inappropriately relied on the assignment of income doctrine cases, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940), which, while relevant in family transactions, were not relevant in a arm's length transaction.

> The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant.

g. ***Tax Court: Wisconsin attorney's fees subject to the AMT trap because of assignment of income doctrine. Tax Court majority holds that it was Congress's doing; dissents state that courts can cure the problem.** Kenseth v. Commissioner, 114 T.C. No. 26 (5/24/00) (reviewed, 8-5). The Tax Court adheres to its holdings that contingent attorney's fees paid in an age discrimination settlement are includible in taxpayer's gross income. Judge Ruwe specifically declined to follow the Sixth Circuit's *Estate of Clarks* case, and held that taxpayer had income which he could not assign. Judge Chabot (who tried the case) dissented on the ground that the assignment of income doctrine was court-made, so the court could grant relief. Judge Beghe dissented on the ground that taxpayer lacked control over the attorney's share, so it would not be reasonable to include it in his income.

h. ***Ninth Circuit: Alaska statutory lien law requires entire recovery to be included in taxpayer's gross income.** Coady v. Commissioner, 213 F.3d 1187, 2000-1 U.S.T.C. ¶50,528 (9th Cir. 6/14/00). Attorneys' fees awarded on a wrongful termination suit under Alaska law do not reduce the amount includable in taxpayer's income. Instead, the attorneys' fees are deductible as miscellaneous itemized deductions. The court refused to follow *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), and *Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), but chose instead to follow *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), and *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995). Alaska's statutory attorney's lien provisions do not create a superior lien or ownership interest in the cause of action – as they do in Alabama and Michigan – but specifically subordinates the lien to "the rights existing between the parties to the action or proceeding." Accord *Benci-Woodward v. Commissioner*, 219 F.3d 941, 2000-2 U.S.T.C. ¶50,595 (9th Cir. 7/18/00) (The portion of a taxable damage award retained by the taxpayer's attorney as a contingent fee under California attorney's fee lien law was includable in taxpayer's income, following *Coady*. The Sixth Circuit decision in *Estate of Clarks* was distinguished on the grounds of the different attorney's fee lien law involved there and the inherent conflict with *Estate of Clarks* was ignored.).

i. ***But *Cotnam* doesn't apply to all Alabama attorney's fees.** Foster v. United States, 2000-1 U.S.T.C. ¶50,353, 85 A.F.T.R.2d 1649 (N.D. Ala. 3/13/00). Taxpayer received a favorable jury verdict that included $1,000,000 of [taxable] punitive damages. Under an Alabama statute, the trial judge reduced the punitive damage award to $250,000. Taxpayer had agreed to pay her attorney a contingent fee of 50 % for the trial. For the appeal, the contingent fee arrangement was amended to treat all post-judgment interest collected as an additional contingent fee. The district court held that under *Cotnam* the taxpayer could treat the originally agreed upon contingent as excluded from gross income and received directly by the attorney, but the post judgment interest paid as the additional contingent fee was includable in gross income and deductible under §212. At the point that contingent fee arrangement was negotiated, the taxpayer's claim, which had been upheld by the jury, had value and the "uncertainties" of the appellate process were not sufficient to displace the applicability of the assignment of income principles.

j. ***Whether an profit-seeking expense is deductible under §162 or, on the other hand, under §212, and thereby subject to the myriad of more restrictive ancillary rules, turns on the "origin and character of the claim for which the expense was incurred and whether the claim bears a sufficient nexus to the taxpayer's business."** Guill v. Commissioner, 112 T.C. 325 (6/18/99). Taxpayer was a sole proprietor / independent contractor insurance agent who after having been fired by an insurance company sued the insurance company and collected compensatory damages for breach of contract and conversion of business profits, together with punitive damages. The taxpayer deducted his legal fees on Schedule C, but the IRS took the position that the taxpayer's attorney's fees were deductible under §212 as itemized deductions [subject to the myriad of limitations on deductibility of miscellaneous itemized deduction], but the Tax Court (Judge Laro), in what was described as a case of first impression held that under a variation of the ubiquitous "origin of the claim" test, the attorney's fees were deductible above the line under §162. One wonders how this was a case of first impression since in *Srivastava v. Commissioner*, T.C. Memo. 1998-362 (10/6/98), the Tax Court held that plaintiff's attorney's fees incurred in a defamation suit were §212 expenses, not §162 expenses *even though the defamation related to the taxpayer's conduct of his medical practice*, obviously a trade or business. The court reasoned that whether the defamatory attack was on the personal reputation or the professional reputation, the defamation is personal in nature even though it may have derivative consequences for the business, relying on *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983) and *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). But, in *Fabry v. Commissioner*, 111 T.C. 305 (1998), the Tax Court held that "injury to business reputation" [which in that case resulted from the effect on the taxpayer's products of defective products purchased from a supplier] is not as a matter of law a "personal injury." One further wonders how this aspect of Srivastava can be reconciled with Guill and Fabry other that as an idiosyncratic anomaly attributable to the torturous history of the interpretation of §104(a)(2).

2. Noons v. Commissioner, T.C. Memo 2000-106 (3/28/00). Legal fees to defend criminal charges arising out of the allegedly fraudulent acquisition by a FSLIC employee of an underperforming promissory note from the original lender, which had been placed in receivership by FSLIC, were deductible as a miscellaneous itemized deduction, not as a §162 trade or business deduction, because the taxpayer was not in the trade or business of acquiring and selling promissory notes. The deduction was disallowed under the AMT.

3. **TTREA '98** §2001 amends §26(a) to allow nonrefundable personal credits fully against regular tax liability during 1998, and amends §24(d)(2) to provide that the additional [$400] child tax credit is not reduced by AMT during 1998.

a. **1999 Act.** For taxable years beginning in 2000 and 2001 the child and education credits may offset the excess of regular tax liability over AMT. For years after 2001, the rule reverts to the pre-1998 rule, under which the credits may offset only the excess of regular tax liability over AMT liability.

4. **It's just business – nothing personal (even though he also went to burlesque shows just to listen to the band). At least Gladstone did not try to deduct expenses incurred in his**

quest to save prostitutes. Vitale v. Commissioner, T.C. Memo 1999-131(4/21/99). A Treasury department budget analyst engaged in a part-time activity writing a book about legalized prostitution, titled "Searchlight Nevada," which was published and marketed and in researching and writing a sequel entitled "Nevada Nights, San Joaquin Dawn." Judge Fay found that taxpayer was engaged in the activity for profit and that he was allowed to deduct most of his expenses (including expenses in excess of income from the activity), even though not all were documented; the *Cohan* rule was applied. Amounts paid to prostitutes for "interviews," however, were nondeductible as inherently personal expenses, even to the extent documented by a journal and credit card receipts.

a. **Affirmed in unpublished opinion,** 2000-2 U.S.T.C. ¶50,563, 86 A.F.T.R.2d 5059 (4th Cir. 6/21/00).

5. ***All he needed was a little cooperation from his ex – Wonder why he didn't get it.** Miller v. Commissioner, 114 T.C. No. 13 (3/24/00). Under §152(e)(2) the actual signature of the custodial spouse on the declaration [Form 8332] is crucial to shifting the dependency exemption to the noncustodial spouse. Even though a state court order, which had been signed by the custodial former spouse's attorney, allocated the dependency exemptions to the noncustodial father, the noncustodial father was not entitled to claim the dependency exemptions with respect to his children, even though he attached a copy of the court order to his return, because his former wife had not personally signed a waiver of her right to the claim the exemptions.

6. **Maybe if he'd trampled down some of their shrubs in making good his escape.** Chamales v. Commissioner, T.C. Memo. 2000-33 (2/3/00). O.J. Simpson's neighbors in the Brentwood section of Los Angeles could not deduct as a casualty loss the diminution in value of their home that they attributed to the murder of Nichole Brown Simpson and Ronald Goldman and the subsequent focus on O.J. Simpson as a suspect.

7. Strange v. Commissioner, 114 T.C. No. 15 (3/29/00). The taxpayer paid nonresident state income taxes to nine states on net royalty income derived from interests in oil and gas wells located within those states. In calculating total net royalty income, and thus AGI, the taxpayer deducted the state income taxes they paid. The Tax Court (Judge Parr) held that the revision of § 164 by the Revenue Act of 1964 did not alter the pre-existing law under which state income taxes were deductible only as itemized deductions. State nonresident income taxes [unlike property taxes] are not "attributable" to property held for the production of royalties and, therefore, are not deductible under §62(a)(4) in computing AGI.

8. Rev. Rul. 2000-24, 2000-19 I.R.B. 963 Expenses (registration and transportation) incurred to attend a medical conference relating to the chronic disease of the taxpayer's dependent are deductible medical expenses if the costs are primarily for and essential to the medical care of the dependent. The cost of meals and lodging while attending the conference is not deductible because neither the taxpayer nor the taxpayer's dependent is receiving medical treatment.

9. **No carrots for Mr. Ed helps taxpayer prove that horse breeding is a business not a hobby.** Jordan v. Commissioner, T.C. Memo 2000-206 (7/5/00). A thoroughbred horse breeding activity conducted by taxpayers who did not have "any affectionate attachment to any of their race horses in particular, or to horses in general" and did not use their horses for farm or recreational purposes was conducted with a profit seeking motive. It was not improbable that taxpayers' cumulative losses could be recovered by a single successful foal, and the court could "see no other reason why [taxpayers] would have engaged in the activity and incurred the resulting expenses unless for profit."

10. **Did the Bible foresee the Internal Revenue Code?** Miller v. Commissioner, 114 T.C. No. 32 (6/23/00). The taxpayers held a religious belief that a social security number was the "mark of the Beast" warned against in the Bible at Revelations 13:16-17 and consequently refused to obtain social security numbers for their children. Their religious beliefs, which did not meet the requirements of §1402(g) to excuse them from participation in the Social Security system, however, did not excuse them from complying with the §151(e) requirement to provide an SSN as a condition for claiming the dependency exemption for their children. The requirement that taxpayers provide an SSN for children claimed as dependents, rather than a TIN, which the taxpayers were willing to obtain but which the IRS would not issue because children were eligible for an SSN, did not violate the Religious Freedom Restoration Act because the government has a compelling interest in preventing improper claims of

dependency exemptions and administering the system in a uniform and fair manner. Davis v. Commissioner, T.C. Memo 2000-210 (7/10/00), reached the same result.

11. Who says it's a "net" income tax? What happened to those §212 deductions? Mellon Bank, N.A. v. United States, 47 Fed. Cl. 86; 2000-2 U.S.T.C. ¶50,642, 86 A.F.T.R.2d 5321 (Fed. Cl. 7/17/00). Investment advisor's fees incurred by a trust are excluded from the 67 haircut on miscellaneous itemized deductions only if the expenses "would not have been incurred if the property were not held in such trust. The Court of Federal Claims (Judge Andewelt) reached a conclusion similar to that of the Tax Court and contrary to the Sixth Circuit in *William J. O'Neill Revocable Trust v. Commissioner*, 98 T.C. 227 (1992) (investment adviser fees paid by irrevocable trust are not "administration fees" excluded from §67 disallowance rules by §67(e)), *rev'd*, 994 F.2d 302 (6th Cir. 1993) (investment adviser's fees that would not have been incurred if property had not been held in trust are not subject to 2 percent floor pursuant to §67(e)). Nevertheless the Court of Federal Claims declined to grant summary judgment for government because it would not take judicial notice of fact that individuals often pay investment advisory fees.

12. Listen to your parents and always tell the truth. Novak v. Commissioner, T.C. Memo 2000-234 (8/2/00). The taxpayer was a physician who Arabian horse breeding activity losses were disallowed. despite the fact that he was an expert in horse breeding and hired many experts. Among other things, he did not have a business plan and admitted that he would never be able to recoup the losses – more than $1.2 million over 12 years, without a single profitable year. He also admitted that he became a doctor instead of a school teacher because while he was in college he father advised him "if you ever want to have horses you can't be a school teacher, you've got to find a job where you can make some money, be a doctor or a dentist."

13. No you can't report your W-2 income on schedule C to beat the §67 haircut on deducting employee business expenses. D'Acquisto v. Commissioner, T.C. Memo 2000-239 (8/7/00). A TV commercial voice-over actor was an employee of numerous employers, not an independent contractor, because he did not control how the scripts were performed. His right to pick and choose which jobs to accept did not render him an independent contractor. And he received numerous W-2s without protesting to the issuing employers.

14. The sound and the fury. ILM 200038059 (9/22/00), *modifying* 200034029 (7/25/00). The first legal memorandum determined that the parents of a kidnapped child may take a dependency exemption for the year of the kidnapping, but not thereafter because they may not meet the §152(a) support test for the child. The second legal memorandum determines that where the child was kidnapped by a stranger, i.e., where no individual other than the parents has legal custody of the child or would be entitled to claim a dependency exemption, "it should ordinarily be presumed that the parents have incurred sufficient expenses for the support of the child to satisfy the support requirement of §152(a)."

a. Who would oppose this bill just before Election Day? On 9/26/00, the House unanimously passed H.R. 5117 to permit the parents to continue to claim the dependency exemption, the child credit, the earned income credit, and their filing status for later years [during the child's minority] in which the child remains missing after being kidnapped by a non-family member.

B. Miscellaneous Income

1. Nielsen v. Commissioner, 114 T.C. No. 10 (3/8/00 The taxpayer's residence was condemned by the State of South Dakota for purposes of a federally aided highway construction project and as a result of the condemnation, the taxpayer received $65,000 [for a year not governed by current §121]. Subsequently, the taxpayer received an additional $100,000 of supplemental relocation assistance payments under the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, Pub.L. 91-646, 84 Stat. 1894. The taxpayer claimed that not only were the $100,000 excludable under the provisions of the Relocation Act exempting payments thereunder from income [42 U.S.C. 301], but that the $65,000 received for her home in the condemnation proceeding was likewise exempt and reported no capital gain on the disposition of her home. The Tax Court upheld that Commissioner's determination that the $65,000 was not exempt and that the taxpayer recognized a gain to the extent that the payment exceeded her basis in her residence.

2. Warren v. Commissioner, 114 T.C. No. 23 (5/16/2000) (reviewed 14-3) If a parsonage allowance is paid to a minister, under §107(2) it is excludable up to the amount of eligible expenses actually paid out of the allowance, even though the amount of the allowance exceeds the "fair rental value" of the parsonage, which can occur when the allowance covers mortgage payments in full, as well as real estate taxes, maintenance, utilities, and furnishings for a home owned by the minister. The court rejected the Commissioner's argument that the exclusion under §107(2) was limited to the $58,000 rental value of the minister's home where between $76,000 and $80,000 of total compensation of $77,000 to $99,000 designated as an annual parsonage allowance over three taxable years was expended on qualifying expenditures. The excess of the designated allowance over actual housing expenditures was taxable.

3. **Additional amount of severance payments treated as recovery for wrongful discharge.** Greer v. United States, 207 F.3d 322, 2000-1 U.S.T.C. ¶50,300 (6th Cir. 3/22/00). Held, the additional amount of severance payments [in excess of the amount taxpayer would have been ordinarily entitled to – $331,968 as compared to $51,000] was received in settlement of taxpayer's tort claim for wrongful discharge. Taxpayer was transferred from the position of Ashland Oil's environmental compliance director after completing many negative environmental compliance audits of his employer's petroleum operations; he was discharged because "he did not fit in."

4. **Making the world safe for toasters. The "kinder and gentler" IRS that emerged from the Internal Revenue Service Restructuring and Reform Act of 1998 says that free toasters — at least really cheap free toasters — from your bank aren't income.** Rev. Proc. 2000-30, 2000-28 I.R.B. 113 (7/10/00). On the grounds of "administrative convenience," the IRS will not require a bank depositor who receives a *de minimis* premium to include the value of the premium in gross income. Nor will the depositor be required to reduce the basis in the account by the *de minimis* premium. [A basis reduction would have rendered the account an OID instrument.] The financial institution that provides a *de minimis* premium is not required to report it as interest under § 6049. For these purposes, a "*de minimis* premium" is a non-cash inducement, provided by a financial institution to a depositor to open or add to an account, that does not have a cost to the financial institution in excess of $10 for a deposit of less than $5,000 or $20 for a deposit of $5,000 or more.

5. **New Regs clarify 1954 provision that many of didn't realize was so ambiguous.** T.D. 8890, Definition of a Grantor, 2000-30 I.R.B. 122 (65 F.R. 41332, 7/5/00). Final Reg. §1.671-2(e) dealing with the identification of the grantor of a trust for purposes of the grantor trust rules. The term "grantor" includes any person that directly or indirectly makes a gratuitous transfer of cash or property to a trust, whether or not the person created the trust. If a person creates or funds a trust on behalf of another person, both of them are treated as grantors of the trust, unless the person who created a trust made no gratuitous transfers to it. A gratuitous transfer is any transfer other than a transfer for fair market A transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. An interest in the trust is not property received from the trust.

- "Grantor" includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in investment trusts described in Reg. §301.7701-4(c), liquidating trusts described in Reg. § 301.7701-4(d), or environmental remediation trusts described in Reg. § 301.7701-4(e).
- If a partnership or corporation makes a gratuitous transfer to a trust for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.

XI. PROCEDURE, PENALTIES AND PROSECUTIONS

A. Penalties and Prosecutions

1. Vinick v. United States, 205 F.3d 1, 2000-1 U.S.T.C. ¶50,263, 85 A.F.T.R.2d 1177 (1st Cir. 3/8/2000). A district court determination that the taxpayer was a responsible person under §6672 was reversed because it applied an improper legal standard. The court of Appeals held that the responsible person penalty applies only to persons who exercise daily management of the decisions regarding the payment of debts. Although the taxpayer was a shareholder, director, held the title of

Treasurer, and had the authority to write checks and to hire and fire employees, and, as the corporation's accountant, filed its employment tax returns, during the quarters in question, he did not exercise decision-making control over payment of the corporation's debts [even though he did exercise such control during subsequent quarters].

2. ***It couldn't happen to a nicer guy.** Investment Research Associates, Ltd. v. Commissioner, T.C. Memo. 1999-407 (12/15/99). In a 600-page opinion Burton Kanter was held liable for the §6653 fraud penalty by reason of his being "the architect who planned and executed the elaborate scheme with respect to the kickback income payments . . . . In our view, what we have here, purely and simply, is a concerted effort by an experienced tax lawyer and two corporate executives to defeat and evade the payments of taxes and to cover up their illegal acts so that the corporations [employing the two corporate executives] and the Federal Government would be unable to discover them."

3. Remington v. United States, 210 F.3d 281, 2000-1 U.S.T.C. ¶50,369 (5th Cir. 4/13/00). Partner who is not subject to liability under §6672 is nevertheless liable for law firm's delinquent payroll taxes because §6672 does not preempt the state law under which general partners are liable for partnership debts.

4. United States v. Tenzer, 127 F.3d 222, 97-2 U.S.T.C. ¶50,689 (2d Cir. 9/19/97). Dismissal of failure-to-file indictment of an experienced Long Island tax attorney was reversed. Judge Miner held that defendant was not entitled to the benefit of the IRS voluntary disclosure" policy because he had not paid his taxes or made "bona fide arrangements to pay." Moral: don't be too cute because that can adversely impact a voluntary disclosure; that policy requires taxpayer to be currently compliant and to have made a reasonable offer as to past unsatisfied taxes.

a. **On subsequent appeal after sentencing on remand,** 213 F.3d 34, 85 A.F.T.R.2d 1636 (2d Cir. 4/26/00). The conviction was upheld. New evidence that Tenzer's offer in compromise proposal had been "returned as unprocessable" rather than "rejected" was not material to prior holding that no agreement to pay had been made. But sentence vacated and case remanded for reconsideration of whether sentence should be reduced below guidelines based on mitigating circumstances of Tenzer's offer to settle with IRS, negotiations to pay, and "good intentions" and the IRS' decision to terminate negotiations with respect to Tenzer's offer.

5. **One set of books is required, two is pretty strong evidence of fraud, as well as a big help to the IRS in reconstructing income.** Karcho v. Commissioner, T.C. Memo 2000-213 (7/13/00). Taxpayer operated a video arcade business. The gross receipts deposited in his bank account matched the aggregate amounts shown on his "Daily Income Reports" provided to his accountant and reported for tax purposes. A second set of "Daily Income Reports," which reflected substantially higher income, matched the total cash shown on the "Meter Reading Sheets" for the video games, and even reconciled the differences between the disparate gross receipts. Taxpayer pleaded guilty to criminal tax fraud. The civil case was a slam-dunk for the IRS.

B. Discovery: Summonses and FOIA

1. **1998 Act** §3417 adds new Code §7602(c) to require IRS to give taxpayer "reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made," and to require that the IRS provide a record of such contacts periodically or on request.

a. **The IRS can mess up if it makes third-party contacts without notifying taxpayers in advance; it can also mess up when it sends a prophylactic letter to an unnecessarily large number of taxpayers about possible third-party contacts.** IR-1999-19 (3/2/99). The Service will revise a letter for taxpayers to "more clearly spell out the circumstances surrounding third-party contacts about liability." Beginning 1/18/99, letters began going out to taxpayers stating that the IRS "may need to contact third parties [which] may include, but are not limited to, neighbors, employers, employees and banks." Commissioner Rossotti stated that the letter "mistakenly raised taxpayer concerns about privacy issues."

b. ***The 15-point solution?** IR-2000-8 (2/12/00). IRS will release 15 different clearer, specialized versions of letters and notices alerting taxpayers that third parties might be contacted as part of the collection or examination process. Letters 3164 A through M and Notices 1219A and 1219B are the designations.

2. **Judge Nims denies privilege to tax shelter documents.** Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (10/27/99). Brunswick's transactions identical to ACM's were found to lack economic substance. Judge Nims rejected claims of privilege on discussions during the planning stage of these transactions.

3. Tax Analysts v. IRS, 99-2 U.S.T.C. ¶50,794, 84 A.F.T.R.2d 5457 (D. D.C. 8/6/99), *affirmed in part, vacated in part, and remanded*, 214 F.3d 179, 2000-1 U.S.T.C. ¶50,531 (D.C. Cir. 6/13/00). Closing agreement between Christian Broadcasting Network and the IRS relating to termination of tax liability in connection with CBN's application for restoration of tax exempt status was return information that was not disclosable under FOIA.

4. ***A little privacy remains — A taxpayer who is not under investigation and who has no legal relationship to any other taxpayer under investigation is entitled to notice of a third-party summonses issued by the IRS to the taxpayer's bank with respect to an IRS investigation of another taxpayer.** Ip v. United States, 205 F.3d 1168, 2000-1 U.S.T.C. ¶50,268, 85 A.F.T.R.2d 1095 (9th Cir. 3/7/00). Ip's fiance was a jewelry agent for Diamond Trade Ltd. (DTL). Ip was not an employee, owner, or officer of DTL. The IRS assessed a tax liability against DTL and issued third-party summonses to two banks requesting information relating to DTL and its agents. Believing that Ip deposited DTL sales proceeds into her bank accounts on DTL's behalf, the IRS also summoned Ip's bank records. Ip filed a petition to quash the summonses on the grounds of improper service and lack of notice.

- The district court dismissed the petition, concluding that Ip was not entitled to notice under §4609(c)(2)(D) [then §4609(c)(2)(B) because the summonses were issued "in aid of the collection" of DTL's tax liability.

- The Court of Appeals (Judge Aldisert) reversed, holding that Ip was entitled to notice under §7609(a) because she had no legal relationship to DTL. The court rejected the IRS's argument that the literal language of §7609(c)(2)(D)(i) dispenses with the notice requirement any time a third-party summons is issued "in aid of the collection" of any assessed tax liability. Rather, the court held that the notice exception applies only when the assessed taxpayer "has a recognizable [legal] interest" in the summoned records. Accepting the IRS's interpretation would render meaningless the express language of §7609(c)(2)(B)(ii) which dispenses with notice when a summons is "in aid of the collection of 'the liability . . . of any transferee or fiduciary of any person . . . in clause (i).'" The appeals court distinguished the instant case from *Barmes v. United States*, 199 F.3d 386, 99-2 U.S.T.C. ¶50,103, 84 A.F.T.R.2d 7130 (7th Cir. 12/2/99), on which the IRS relied. Unlike in *Barmes*, there was no fiduciary relationship between Ip and DTL, nor did DTL have any recognizable legal interest in Ip's bank account.

C. Litigation Costs

1. **They tried to shoot the moon in attorney's fees ... and lost.** Barford v. Commissioner, 194 F.3d 782, 99-2 U.S.T.C. ¶50,893, 84 A.F.T.R.2d 6460 (7th Cir. 10/8/99). If a case involves multiple significant issues and the government's position is substantially justified with respect to some but not with respect to others, the taxpayer may be required to allocate litigation costs among the issues, and if the taxpayer cannot or fails to allocate the costs among the issues, an attorney's fees award may be denied completely.

2. Pietro v. Commissioner, T.C. Memo. 1999-383 (11/24/99) (awarding attorney's fees of more than double the statutory maximum because there were few attorneys in taxpayers geographical region with the specialized international taxation expertise required to handle their case and the services could not have been obtained at a lower rate).

D. Statutory Notice

1. REG-104939-99, 64 F.R. 63768, 11/22/99. Proposed regulations defining "last known address" in relation to the mailing of notices of deficiency and other notices, statements and documents. Under these proposed regulations, the Service would annually update its address records from the U.S. Postal Service's National Change of Address database.

2. Section 6330 doesn't give the taxpayer two bites at the underlying tax liability. Goza v. Commissioner, 114 T.C. No. 12 (3/17/00). The Tax Court has jurisdiction to review the Commissioner's determination not to accord a hearing under § 6230 in response to taxpayer's claims that a previously assessed deficiency was unconstitutional. Pursuant to §6330(c)(2)(B), the taxpayer was not entitled to contest the underlying tax liability in a §6330 proceeding because the taxpayer had received a valid deficiency notice for the year in question and did not petition the Tax Court for a redetermination.

3. Nor can the taxpayer say "I'll take mine later." Sego v. Commissioner, 114 T.C. No. 37 (6/30/00). The Tax Court lacked jurisdiction to review a notice of intent to levy under §6330 because the taxpayer had consciously refused delivery of the notice of deficiency.

4. Should taxpayer's lawyer have ignored the undated 90-day letter and let the statute of limitations expire? Smith v. Commissioner, 114 T.C. No. 29 (6/8/00). A deficiency notice which failed to include a date in the section entitled "Last Day to File a Petition With the United States Tax Court" is valid where the taxpayers received the notice prior to the expiration of the §6501 limitations period and filed a timely Tax Court petition. Judge Foley held that Congress failed to prescribe what the consequences of IRS failure to follow the requirement of §3463(a) of the IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685, 767, that "The Secretary . . . shall include on each notice of deficiency . . . the date determined by [the IRS] as the last day on which the taxpayer may file a petition with the Tax Court."

E. Statute of Limitations

1. *Estimated tax payments are tax "payments" on the due date of the return and the statute of limitations stop watch on refunds starts ticking. Baral v. United States, 120 S. Ct. 1006, 2000-1 U.S.T.C. ¶50,226, 85 A.F.T.R.2d 941 (U.S. 2/22/00). Under §6513(b) estimated tax payments are deemed to have they been "paid" on the due date (including extensions) for the taxpayer's return, not on the later date on which a delinquent return is filed. Thus a refund of overpayments of estimated taxes was time barred by §6511(b)(2)(A) because the taxpayer's return seeking the refund was delinquent by more than three years (after taking into account the automatic extension period).

2. A refund claim made on a delinquent return by definition has been filed within three years of filing the return. Weisbart v. United States, 222 F.3d 83, 2000-2 U.S.T.C. ¶50,641, 86 A.F.T.R.2d (2d Cir. (7/28/00). The Second Circuit held that a return filed more than three years after its due date and which sought a refund of over-withholding was a timely refund claim under §6511(a), a position that even the government conceded was correct [following Rev. Rul. 76-511, 1976-2 C.B. 428]. The refund claim remains limited, however, by the look-back rule of §6511(b), which limits the amount of the refund to taxes paid within a period equal to three years, plus any period for which the filing date was extended, prior to filing the claim. Thus, because the taxpayer in had been granted a four month automatic extension of the time to file and had filed his return exactly three years and four months after the unextended due date, the §6511(b) limitation did not apply. In determining when the refund claim/return was filed, the court interpreted Reg. §301.6402-3(a)(5) and §301.7502-1 to apply the timely mailed timely filed mailbox rule applies to a refund claim in the form of a delinquent return. *Contra Miller v. United States,* 38 F3d 473 (9th Cir. 1994), holding that if a return is not filed within two years of the due date, a refund claim for withheld taxes made in the delinquent return is time barred under §6511(a).

F. Miscellaneous

1. *Supreme Court holds that state law does not control the determination of whether a disclaimed interest was a property right for tax lien purposes. Drye v. United States, 120 S.Ct. 474, 99-2 U.S.T.C. ¶51,006 (12/7/99) The Court addressed whether a federal tax lien was defeated by a taxpayer-beneficiary's disclaimer of a bequest that under state law related back to the testator's death and caused the property to pass as if the disclaiming beneficiary had predeceased the testator. In holding that the disclaimer did not defeat the federal tax lien, even though the taxpayer's shoes may have worn out under state law, the Court first summarized its prior holdings in a number of cases and then applied those principles to the issue at hand.

> The question whether a state-law right constitutes 'property' or 'rights to property' is a matter of federal law." ... We look initially to state law to determine what rights the

taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state- delineated rights qualify as "property" or "rights to property" within the compass of the federal tax lien legislation. ...

Just as "exempt status under state law does not bind the federal collector," ... so federal tax law "is not struck blind by a disclaimer ... ." It is beyond debate ... that under Arkansas law Drye had, at his mother's death, a valuable, transferable, legally protected right to the property at issue. .... ([A]lthough Code does not define "property" or "rights to property," appellate courts read those terms to encompass "state-law rights or interests that have pecuniary value and are transferable". [U]nder Arkansas law, and the assignment will be enforced when the expectancy ripens into a present estate.

In sum, in determining whether a federal taxpayer's state-law rights constitute "property" or "rights to property," "[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property." ... Drye had the unqualified right to receive the entire value of his mother's estate (less administrative expenses), ... or to channel that value to his daughter. The control rein he held under state law, we hold, rendered the inheritance "property" or "rights to property" belonging to him within the meaning of § 6321, and hence subject to the federal tax liens that sparked this controversy.

This holding makes it clear two important principles. First, state law does not determine whether or not a property right exists. State law determines only the scope of the taxpayer's rights to the property or interest in question. Federal law then determines whether or not that is an interest to which a tax lien may attach. Second, federal, not state law, determines when a taxpayer's rights to property (or an interest in property) have terminated or been so limited that a tax lien is extinguished.

2. **Federal law, not state law, determines extent of tax lien.** Pletz v. United States, 221 F.3d 1114, 2000-2 U.S.T.C. ¶50,660, 86 A.F.T.R.2d 5575 (9th Cir. 8/10/00). A tax lien against one spouse who owns property with the other spouse, against whom there is no deficiency, as tenant by the entirety is a lien against the taxpayer's present interest. The tax lien is not limited to the debtor / taxpayer's survivorship interest to which a state law creditor's judgment lien would have been limited. The lien can be foreclosed by sale of the entire property as long as the other spouse is compensated.

3. ***The quality of mercy is not strained . . . .** Little v. Commissioner, 113 T.C. 474 (12/29/99). The taxpayer was the administrator of an estate. During administration of the estate, he received information indicating possible income tax liabilities of the estate, which he provided to the estate's lawyer, who erroneously and repeatedly advised taxpayer that the estate had no tax liabilities and advised him to make disbursements and distributions. Acting in good faith, taxpayer followed this advice and eventually closed the estate without paying the estate's income tax liabilities. The IRS sought to impose the unpaid income tax liabilities on the administrator under 31 U.S.C. §3713(b) [which imposes personal liability on a fiduciary who pays others before paying claims of the United States]. Noting that a long line of cases has limited liability under 31 U.S.C. §3713(b) to situations in which a fiduciary knowingly disregards debts due to the United States, the Tax Court (Judge Ruwe) declined to hold the taxpayer liable. In this case the taxpayer-fiduciary reasonably and in good faith relied on an attorney's advice there were no debts due to the United States before paying other claims, and he thus did not knowingly disregarded debts due to the United States.

4. **Checkbox Initiative to begin with the 2001 Filing Season.** IR-2000-23, 2000-I.R.B. (4/12/00). Paid preparers, with their clients' permission, would be allowed to work directly with the IRS to resolve tax return processing issues. A checkbox would permit taxpayers to designate their paid individual preparer to resolve such issues.

5. Notice 2000-12, 2000-9 I.R.B. 727 (2/11/00). Pilot program for pre-filing agreements (PFAs), under which large businesses may request examination and resolution of specific issues relating to tax returns expected to be filed between September and December 2000. These PFAs would be treated as closing agreements, and would be confidential return information under §6103(b)(2)(A).

6. **Corporation suspended for failure to pay state income taxes lacked the capacity to file a petition to the Tax Court.** David Dung Le, M.D., Inc. v. Commissioner, 114 T.C. No. 18

(4/18/00). A corporation the state charter of which had been suspended for nonpayment of state taxes lacked capacity to file a petition in the Tax Court because under state law it lacked the capacity to bring suit. The reinstatement of its charter after the 90 day period for filing a Tax Court petition did not validate the petition filed during suspension and did not toll the 90 day period for filing the petition.

7. Notice 2000-35, 2000-29 I.R.B. 118 (6/26/00). The procedures for issuing letter rulings, determination letters, and information letters, as well as for furnishing technical advice, continue to apply despite the reorganization of the Office of Chief Counsel.

8. ***You still can't get innocent spouse relief if you had reason to know of the understatement and enjoyed the benefit of the unreported income.** Butler v. Commissioner, 114 T.C. No. 19 (4/28/00). The taxpayer, who was the wife of a physician who owned an S corporation that conducted a gardening business, petitioned for innocent spouse relief with respect to unreported income that should have been passed-through from her husband's S corporation. The petition was filed under §6103(e), but was treated as an election under §6015(b)(1) because the case was still pending on effective date of §6015(b)(1). Relief was denied because the wife, who had a college education and owned and operated her own S corporation, was responsible for family finances, including tax return preparation, enjoyed a high standard of living, and since the husband concealed no financial information from her and she had actual knowledge of the transaction giving rise to the unreported income, had reason to know of the understatement. The court also held that as part of a deficiency proceeding in which the taxpayer has affirmatively raised the innocent spouse defense, the Tax court has jurisdiction to review the Commissioner's denial of equitable relief under §6015(f). Section 6015(e) does not limit review to denial of relief under §6015(b) or (c). The court will apply an "abuse of discretion" standard. For the same reason that relief was denied under §6015(b)(1), the court found that the Commissioner had not abused his discretion under §6015(f).

a. Fernandez v. Commissioner, 114 T.C. 324 (5/10/00). Section §6015(e)(1)(A) confers jurisdiction to review the Commissioner's denial of equitable relief in a "stand alone" petition, apart from any deficiency determination, even though the taxpayer could not qualify for relief under §6015(b) or (c) because of failure to file a proper election. Charlton v. Commissioner, 114 T.C. No. 22 (5/16/2000) is to the same effect.

(1) AOD 2000-06, the IRS acquiesces in *Fernandez*, and now agrees that it will no longer contest the Tax Court's jurisdiction to review claims for equitable relief under §6015(f) if the requirements of §6015(e) are met. 2000 TNT 190-14. (9/29/00)

b. Charlton v. Commissioner, 114 T.C. 333 (5/16/00). A husband who prepared a joint tax return on which income from his [now former] wife's sole proprietorship was understated was not entitled to innocent spouse relief under §6015(b) because even though he relied on wife's inaccurate, summary he had access to the business' books and therefore had reason to know of the understatement, citing case law under former §6013(e)(1)(C) as support. However, apportioned liability under §6015(c) and (d) was available because husband did not have actual knowledge of understatement because other conditions prerequisite had been met and request for apportioned liability was timely. The court also held that it had jurisdiction to review the Commissioner's denial of §6015(f) relief for the wife.

c. **And the Service throws in the towel.** The IRS has announced that it will no longer challenge the Tax Court's jurisdiction [as it did in Butler, Fernandez, and Charlton] to review denials of claims for innocent spouse relief under §6015(f), regardless of whether an election was made under §6015(b) or (c). 2000 TNT 111-8 (6/8/00).

d. Corson v. Commissioner, 114 T.C. 354 (5/18/00). Where one spouse elects innocent spouse status and the Commissioner grants such relief in a stipulated settlement of a case docketed in the Tax Court, the non-electing spouse should be afforded an opportunity to litigate the Commissioner's decision to grant relief from joint and several liability to the electing spouse. Judge Nims held that §6015(e)(4) grants the non-electing spouse some "participatory entitlement." In a docketed Tax Court case, the non-electing spouse has the "opportunity to become a party" in order that he may have his day in court, particularly in a stipulated settlement, which is "subject to the Court's discretionary review and may be rejected in the interests of justice."

e. **More self-executing statutes in the form of directives to promulgate rules.** King v. Commissioner, 115 T.C. No. 8 (8/10/00). Mr. & Mrs. King recevied separate deficiency notices after they were divorced. Mr. King did not contest the deficiency, but Mrs. King filed a free-standing §6015(e) petition in the Tax Court that sought innocent spouse relief but did not contest the deficiency. Section 6015(e)(4) directs the Tax Court to establish rules under which a spouse who joined in the joint return but is not seeking innocent spouse relief receives notice and an opportunity to intervene as a party to petition filed by the other spouse seeking innocent spouse relief. Interim Rules 324(a) and 325(b) deal with notice and intervention, respectively, but are not yet complete. The Tax Court has interpreted §6015(e) to be self-operative to require the Commissioner to notify the other spouse (or former spouse) of his or her right to intervene to contest the claim for relief "whenever in the course of any proceeding before the Court, a taxpayer raises a claim for relief from joint liability under section 6015 and the other spouse or former spouse is not a party."

(1) AOD 2000-07, the IRS acquiesces in *King*, and stated that it would apply the notice and intervention rules to all cases in which an innocent spouse issue is raised. 2000 TNT 190-13 (9/29/00).

f. ***When the legislative history is ambiguous, read the statute. Tax Court majority holds that the test for knowledge under the §6015(c)(3)(C) separate liability election is the same as that under former §6013(e)(1)(C), which is that knowledge of an item of omitted income is sufficient to deny relief even if the spouse has no reason to believe that the way the item was reported on the return was correct.** Cheshire v. Commissioner, 115 T.C. No. 15 (8/30/00) (reviewed, 11-4). A spouse who has actual knowledge of the transaction giving rise to omitted income has "reason to know" of the understatement and is not entitled to innocent spouse relief under §6015(b). The taxpayer's proposed standard based on a prudent taxpayer being expected to know of the understatement was rejected as providing too broad an escape hatch form liability. More importantly, the Tax Court (Judge Jacobs) held that. for the spouse to be denied apportioned liability relief, §6015(c)(3)(C) does not require actual knowledge of whether the entry on the return is or is not correct. The applicable knowledge standard under §6015(c)(3)(C) is "an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof)." Thus because when the spouse seeking apportioned liability in *Cheshire* signed the joint return, she was aware of the amount, the source, and the date of receipt of a retirement distribution received by her then husband, she was denied apportioned liability, even though at that time she misunderstood how much of the retirement distribution properly was taxable and thus did not know that the amount of income was understated. The court declined to follow a statement in H. Conf. Rept. 105-599, at 253 (1998) that "if the IRS proves that the electing spouse had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item." The court did however, find Commissioner abused his discretion in failing to grant equitable relief under from penalties under §6015(f), even though the failure to grant equitable relief on the underlying deficiency was not an abuse of discretion. The taxpayer relied on her husband's description of the tax consequences of the transaction and his representations that he had been advised by a CPA and had no reason to doubt him.

- Judge Jacobs writing for the majority held that wife was properly denied innocent spouse treatment under §6015(c)(3)(C) where she had knowledge that her husband had received a distribution from his retirement plan. Wife was told by her husband that their accountant had advised him that amounts used to pay off mortgage could be excluded from income the same way that the portion of the distribution that was "rolled over" was treated. The majority held that wife does not need to have knowledge of the tax consequences of the item or that the entry on the return is incorrect. The court relied on former §6013 cases , such as Wicksell v. Commissioner, 215 F.3d 1335 (9th Cir. 2000), aff'g without published opinion T.C. Memo. 1999-32, and Bokum v. Commissioner, 94 T.C. 126 (1990), aff'd, 992 F.2d 1132 (11th Cir. 1993), to the effect that knowledge of the legal consequences of an item may be presumed if the spouse has knowledge of the item.
- The dissenting opinions (Judges Parr, Colvin, Marvel, and Gale), based on the legislative history, would limit denial of relief under §6015(c)(3)(C) to cases in which the spouse actually knew of the understatement of the item). Judge Colvin's dissent is based upon the conclusion that §6015(c) was enacted to make clear that the spouse must have had "actual knowledge that the treatment of the item on the tax return was incorrect" in order to be denied innocent spouse treatment.

9. **Take those Tax Court requests for admissions seriously, or forever hold your peace.** United States v. Boyce, 2000-1 U.S.T.C. ¶50,341, 85 A.F.T.R.2d 1938 (SD Cal. 3/22/00). Res judicata attaches to a Tax Court judgment based on the taxpayer's failure to answer requests for

admission, which, as a result of the taxpayer's failure to answer, under the Tax Court rules were deemed to be true. Summary judgment to reduce assessment to a judgment was granted.

10. **Bye-bye Bivens.** Shreiber v. Mastrogiovanni, 214 F.3d 148, 2000-1 U.S.T.C. ¶50, 532, 85 A.F.T.R.2d 1958 (3d Cir. 5/31/00). A *Bivens* action does not lie against an IRS agent for alleged violations of a taxpayer's constitutional rights in the course of making an assessment because Congress has created an extensive scheme [e.g., §7433] providing remedies to a taxpayer complaining of the conduct of government officials in connection with tax assessments and collections.

11. Offiler v. Commissioner, 114 T.C. No. 30 (6/19/00). The taxpayer's failure to request a §6330 review by Appeals within 30 days of receipt of notice of intent to levy by the IRS bars the taxpayer from subsequently seeking review by Tax Court; under §6330(d), the Tax Court's jurisdiction to review IRS levies is limited to review of determinations by Appeals.

12. **Section 6330 hearings before Appeals are informal.** Davis v. Commissioner, 115 T.C. No. 4 (7/31/00). A taxpayer's right to a pre-levy hearing before an Appeals office under §6330 does not include the right to subpoena and (cross)examine witnesses as part of the hearing. When it enacted §6330, Congress was aware of the informal nature of Appeals hearings. In the absence of any showing by the taxpayer of irregularity in the assessments, the Appeals officer may rely on Form 4340 to verify the proper assessment of tax.

13. **This guy needs a lawyer—or, at least, a calendar.** McCone v. Commissioner, 115 T.C. No. 7 (8/8/00) Section 6330(d)(1) extends the period for appealing an adverse decision in an Appeals hearing before levy under §6330 for an additional 30 days after a determination of another court, e.g., a district court, that an appeal filed in that court was filed in the wrong court, i.e., because the appeal related to unpaid income tax and the district court had no jurisdiction. If the appeal to the wrong court is untimely as well, the additional 30 day extension to appeal to the Tax Court does not apply. [McCone's *pro se* Tax Court petition was also filed more than 30 days after the district court dismissed.]

XII. TAX SHELTERS

A. In General

1. For corporate tax shelters, see IV.H., above.

2. United States v. Estate Preservation Services, 202 F.3d 1093, 2000-1 U.S.T.C. ¶50,203, 85 A.F.T.R.2d 603 (9th Cir. 1/25/00) (Sneed, J.). Affirms preliminary injunctions under §6700 ordered by the district court against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters, i.e., asset protection trusts.

- Promotional materials advised that assets transferred tax-free into such trusts took a fair market value basis. "The APT manual represented that taxpayers could transfer equipment into an APT at no cost to the trust, and thereby give the trust a higher basis in the equipment than it had in the hands of the taxpayer. The district court did not commit clear error in holding these statements to be fraudulent."

3. **Lawyer / tax shelter partners were negligent because they did not reasonably rely on NYU tax professor Guy Maxfield.** Addington v. Commissioner, 205 F.3d 54, 2000-1 U.S.T.C. ¶50,251 (2d Cir. 2/29/00). Three partners of NYC law firm Sann & Howe did not reasonably rely on Maxfield, who was "of counsel" to the firm, for their investment in the "Plastic Recycling" programs [transactions involving the sale and leaseback of Sentinal recyclers]. Although they learned of the programs from Maxfield and allegedly relied on his investigation, Maxfield had disclaimed knowledge of the plastics industry and questioned whether the offering materials correctly valued the recycling machines. Judge Sotomayor held that the taxpayers – particularly in light of their own sophistication—should have recognized the necessity of performing their own investigations and that their reliance on Maxfield was objectively unreasonable.

- Maxfield testified that he viewed his role as a "conveyor of information and . . . impressions," and that he had "made it very clear" to the taxpayers that the investment was "their business decision," and not his.

• The court further held that taxpayers could not justifiably rely on John Taggart , who had been retained to draft the offering memoranda and tax opinions for the partnerships in the programs and owned a 6.66 percent interest in one of the partnerships, because it should have been clear to the taxpayers that Taggart could not advise them because of a conflict of interest.

XIII. WITHHOLDING AND EXCISE TAXES

A. Employee/Independent Contractor and Employment Tax

1. ***Court defers to reasonable IRS interpretation.** Morrison Restaurants, Inc. v. United States, 118 F.3d 1526, 97-2 U.S.T.C. ¶50,598, 80 A.F.T.R.2d 5999 (11th Cir. 8/12/97). Under §3111(a) & (b) and 3121(q), IRS could validly assess employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares.

a. Fior D'Italia Inc. v. United States, 21 F. Supp. 2d 1097, 98-2 U.S.T.C ¶50.840 (N.D. Calif. 9/18/98) holds that the IRS lacks authority to assess employer's share of FICA without determining the tip income of individual employees.

b. Bubble Room Inc. v. United States, 159 F.3d 553, 98-2 U.S.T.C ¶50,799 (Fed. Cir. 10/16/98). IRS has statutory authority to assess FICA taxes against an employer without determining the tip income of individual employees and awarding wage credits to the employees.

c. ***Is the Northern District of Florida still in the Eleventh Circuit?** Quietwater Entertainment, Inc. v. United States, 80 F. Supp. 2d 1323, 99-2 U.S.T.C. ¶50,965, 84 A.F.T.R.2d 5007 (N.D. Fla. 6/28/99). The IRS determined a deficiency in the employer's share of FICA taxes for tips to employees in its restaurant. In doing so, the IRS used a modified *McQuatters* formula [T.C. Memo, 1973-240], on an aggregate basis, a methodology approved by the Eleventh Circuit in *Morrison Restaurants v. United States,* 118 F.3d 1526 (11th Cir. 1997), and presumed a 12 percent tip rate for cash bills and a 16 percent rate for credit card bills.. District Court Judge Vinson held that the 11th Circuit got it wrong in Morrison and that §6053(c), which requires withholding by the employer of the employee's share of FICA based on a presumed 8 percent tip rate implicitly caps the assessment of the employer's share at 8 percent as well and prescribes the only available allocation methods, implicitly proscribing aggregate assessments of the employer's share.

d. ***The answer is yes! *Quietwater* reversed per curiam.** Quietwater Entertainment, Inc. v. United States, 220 F.3d 592, 2000-2 U.S.T.C. ¶50,540, 85 A.F.T.R.2d 2195 (11th Cir. 6/7/00) (unpublished). Holds that *Morrison* controls this case, reverses with directions to enter summary judgment for the government.

e. **How will this affect service in Cocco Pazzo?** 330 West Hubbard Restaurant Corp. v United States, 203 F.3d 990, 2000-1 U.S.T.C. ¶50,225, 85 A.F.T.R.2d 869 (7th Cir. 2/15/00). Under §§3111(a) & (b) and 3121(q), IRS could validly assess employer's share of FICA with respect to restaurant employees' unreported tips on the basis of an aggregate computation, without determining individual employees' shares. Deferring to both the Federal and Eleventh Circuits, held that the IRS is authorized to collect an employer's FICA taxes without first assessing individual employees and crediting their Social Securities earnings records. Judge Coffey also deferred to the IRS interpretation of §3121(q).

2. American Airlines Inc. v. United States, 204 F.3d 1103, 2000-1 U.S.T.C. ¶50,236, 85 A.F.T.R.2d 1005 (Fed. Cir. 2/24/00), *rev'g and remanding in part and aff'g in part*, 40 Fed. Cl. 712, 98-1 U.S.T.C. ¶50,323 (1998). On summary judgment, the Court of Claims held that as an employer American Airlines was liable for withholding and FICA taxes on per diem payments provided to employees under collective bargaining agreements; exclusion was limited to $14 per day (as allowed by Reg. §1.274-5 as then in effect) because the per diem payments were not excludable as working condition fringe benefits as amounts reasonably expected to be incurred on an overnight trip; other per diem allowances were not excludable as working condition fringe benefits because they were paid in connection with turnaround trips that did not require "sleep or rest." It also held that credit card vouchers [of $100 per employee] did not constitute *de minimis* fringe benefits because the employer could have easily accounted for them, a result confirmed by the subsequently-issued Reg. §1.132-6T(c). On the first issue, the Federal Circuit reversed and remanded, holding that the Court of Claims erred in holding that there was not a factual

dispute regarding whether American reasonably believed its per diem was less than or equal to the employee's expenses. But it affirmed the holding that the per diem allowances, for which substantiation was not required, could not be working condition fringe benefits. On the second [turn-around per diem] and third [AmEx vouchers] issues, the Federal Circuit affirmed.

3. Wuebker v. Commissioner, 205 F.3d 897, 2000-1 U.S.T.C. ¶50,254, 85 A.F.T.R.2d 1057 (6th Cir. 3/3/00), *rev'g* 110 T.C. 431 (1998). The taxpayer was a farmer who received payments for enrolling land in the Conservation Reserve Program ("CRP") under the Food Security Act of 1995, removing the land from production and establishing a vegetative cover.

- The **Tax Court** held that the payments were rents from real estate, even though related to farming to farming activities, and pursuant to Treas. Reg. §1.1402(a)-4(d) were not subject to self employment tax. Frederick Wuebker and his wife owned 258 acres of land, of which 214 acres was tillable; the rest of the land was highly erodible. After years of farming the property, the Wuebkers agreed to enroll their tillable land into the CRP in 1991. In exchange for annual payments, the Wuebkers established and maintained vegetative cover; disallowed grazing, harvesting, and other commercial use of the ground cover; and controlled weeds, insects, and pests. Under the CRP agreement, the Wuebkers were required to turn the soil and plant seed in 1992; the Wuebkers used their existing farming equipment to accomplish these tasks. Thereafter, the upkeep was minimal. The Wuebkers received $ 18,000 per year in CRP payments in 1992 and 1993, which they reported as farm rental income that was not subject to self-employment tax. The IRS determined that the amounts received under the CRP plan constituted income from the trade or business of farming that was subject to self-employment tax under §1401. The Tax Court held that the payments were rental payments excludable from self-employment income under §1402. The IRS appealed.

- **The Sixth Circuit reversed.** Taxpayer continued to engage in the farming business while receiving the payments and receipt of the payments was conditional upon performing activities intrinsic to farming, such as tilling, seeding, fertilizing and weed control that required the use of the taxpayer's farm equipment. The payments were not "rent" for the "use" of the farmland by the government, and characterization of the payments as "rentals" in the CRP statute, regulations, and contract did not render them so. A dissent would have affirmed because the taxpayers were prohibited from permitting any grazing on or harvesting of the cover crop.

- Reversing, Judge Gilman held that the CRP payments constituted self-employment income, concluding that the income was derived from the Wuebkers' trade or business of farming. Contrary to the Tax Court's conclusion, the appeals court found that there was a sufficient nexus between the CRP payments and the Wuebkers' farming operations, noting that the couple was actively engaged in the farming business both before and during the term of their CRP agreement. The agreement, Judge Gilman pointed out, merely required the Wuebkers to perform ongoing tasks with respect to the land placed in the CRP. Thus, the CRP payments were "'in connection with' and had a 'direct nexus to' [the Wuebkers'] ongoing trade or business," the court concluded. Rejecting the Wuebkers' argument to the contrary, Judge Gilman concluded that the CRP payments were not "rent" because they were not made in exchange for the "use or occupancy of property." The appeals court disagreed with the notion that the restrictions the Agriculture Department imposed on the Wuebkers' use of their land constituted "use" by the agency, pointing out that the couple continued to maintain control over and free access to their land. Judge Gilman also disagreed with the Tax Court's determination that the Wuebkers' service-performance obligations under the CRP agreement were insignificant and merely incidental to the contract's primary purpose. The essence of the CRP, the court explained, was to prevent participants from farming the enrolled property and to require them to perform various activities in connection with the land continuously throughout the life of the contract. Thus, Judge Gilman reasoned, the Wuebkers' maintenance obligations were significant and the payments were compensation for their labor.

- Dissenting, Circuit Judge Nathaniel R. Jones found that the substantial and wide-ranging limitations the CRP imposed on the Wuebkers' use of their land constituted "use" by the Agriculture Department as contemplated by the ordinary definition of "rent."

4. A reverse reasonable comp case; salaries paid to S corporation shareholder-employees must not be too *low !* Joly v. Commissioner, 211 F.3d 1269, 2000-1 U.S.T.C. ¶50,315, 85 A.F.T.R.2d 1234 (6th Cir. 3/20/00), *aff'g* T.C. Memo. 1998-361 (10/5/98). The taxpayers were shareholders of an S corporation who performed services for the corporation but drew no salaries. A portion of the shareholders' profit shares was recharacterized as salary, giving rise to employment tax liability. The assessment of accuracy related penalties was upheld.

XIV. TAX LEGISLATION

A. Vetoed

1. H.R. 4810, **Marriage Tax Relief Reconciliation Bill of 2000** was passed by Congress and sent to President Clinton. The bill would increase the standard deduction and the 15 percent bracket amount for married couples to twice the amount for single taxpayers. The 15-percent bracket amount increase would be phased-in between 2000 and 2004. The bill would also provide marriage penalty relief for the earned income credit by increasing the phaseout amount for joint returns by $2,000 (indexed). Vetoed by President Clinton on 8/5/00.

2. H.R. 8, the **Death Tax Elimination Bill of 2000**, was passed by Congress on 7/21/00 and sent to President Clinton. The bill would repeal the estate, gift, and generation-skipping transfer taxes in 2010, after a 10-year phaseout. It would also provide for carryover basis at for property passing from a decedent after 2009, with an exemption for properties worth up to $1.3 million plus an additional $3 million for property acquired by a surviving spouse. Vetoed by President Clinton on 8/31/00.

B. Enacted

1. P.L. 106-36, the **Miscellaneous Trade and Technical Corrections Act of 1999** was signed by President Clinton on 6/25/99.

2. H.R. 1180, the Ticket to Work and Work Incentives Improvement Act (or **Tax Relief Extension Act of 1999**) was approved by Congress on November 19, 1999 and was signed by President Clinton on December 17, 1999. The legislation includes: (a) Five-year extension of the research credit; other extenders; (b) Three-year extension protecting the personal credits, i.e., the $500 per child credit, etc. from being reduced by the individual alternative minimum tax; (c) New CS credit applicable to existing credit for electricity produced by wind and closed-loop biomass facilities; (d) Prohibits disclosure of APAs; (e) Denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements; and (f) Changes the §6654 percentage to 108.6.

3. President Clinton signed (on 7/1/00) H.R. Res. 4762, 106 Pub. L. 230, 114 Stat. 477, adding new §527(j), which requires reporting and disclosure by **"section 527" political organizations** of expenditures and contributions. Naturally, §501(c)(5) labor unions' political expenditures are not covered by the legislation.

a. IR-2000-50. Form 8871 is prescribed for filings by section 927 political organizations.

C. Pending

1. H.R. 1843, the **Comprehensive Retirement Security and Pension Reform Act** (Portman-Cardin Pension Reform Bill) was approved by the House on 7/19/00. IRA contribution limitations are increased from $2,000 to $5,000 and pension contribution limitations are also increased.

2. On 7/27/00, the House Ways and Means Committee approved H.R. 4986, the **FSC Repeal and Extraterritorial Income Exclusion Bill of 2000**. The bill would apply to transactions occurring after 9/30/00, in response to the 2/24/00 World Trade Organization appellate ruling [with 10/1/00 deadline] that FSCs are a prohibited export subsidy because FSC benefits are contingent on exporting property.

3. On 7/27/00, the House passed H.R. 4865, the **Social Security Benefits Tax Relief Bill of 2000**. The bill would rescind the 1993 increase (from 50 percent to 85 percent) in the portion of social security benefit payments subject to taxation.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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