

2011

## Recent Developments In Federal Income Taxation

Ira B. Shepard

---

### Repository Citation

Shepard, Ira B., "Recent Developments In Federal Income Taxation" (2011). *William & Mary Annual Tax Conference*. 666.  
<https://scholarship.law.wm.edu/tax/666>

# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

By

Ira B. Shepard  
Professor Emeritus, University of Houston Law Center  
Houston, Texas 77204  
Tele: 713-743-2246  
Fax: 713-743-2131  
e-mail: [ishepard@uh.edu](mailto:ishepard@uh.edu)

William & Mary Tax Conference  
November 11, 2011

Note: This outline was prepared jointly with Martin J. McMahon, Jr., Stephen C. O'Connell Professor of Law, University of Florida College of Law, Gainesville, FL and Daniel L. Simmons, Professor of Law, University of California Davis, Davis CA.

*This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted — unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide Dan and Marty the opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to the three of us, at least) — income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services. Please read this outline at your own risk; we take no responsibility for any misinformation in it, whether occasioned by our advancing ages or our increasing indifference as to whether we get any particular item right. Any mistakes in this outline are Marty's responsibility; any political bias or offensive language is Ira's; and any useful information is Dan's.*

## I. ACCOUNTING

### A. Accounting Methods

1. **New and improved automatic consent procedures for changes of accounting methods.** Rev. Proc. 2011-14, 2011-4 I.R.B. 330 (1/11/11). This revenue procedure provides automatic consent procedures for a wide variety of accounting method changes. Rev. Proc. 97-27 *clarified and modified*; Rev. Procs. 2001-10, 2002-28, 2004-34, and 2006-56 *modified*; Rev. Procs. 2008-52 and 2009-39 *superseded in part*.

### B. Inventories

### C. Installment Method

### D. Year of Inclusion or Deduction

1. **The long arm of § 267(a)(2).** Bosamia v. Commissioner, T.C. Memo. 2010-218 (10/7/10). Section 267(a)(2) applies to the determination of the cost of goods sold

when an accrual method taxpayer purchases from a related cash method taxpayer property that will be included in the purchaser's inventory. Thus, because the costs were not paid within two and one-half months after the close of the purchaser's taxable year, the amounts could not be included in COGS. Furthermore, because the adjustment was a change of accounting method, § 481 applied to eliminate from the COGS amounts previously included in costs of goods sold with respect to amounts that remained unpaid in the current year for goods purchased in years beyond the statute of limitations.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

1. **These winds blow in capital contributions.** Southern Family Insurance Company v. United States, 106 A.F.T.R.2d 2010-7200 (M.D. Fla. 12/1/10). Following Hurricane Andrew, the State of Florida created a joint underwriting association (JUA) as a windstorm insurer of last resort. State legislation provided for a "takeout bonus" payable to private insurers for each risk they removed from the JUA. The taxpayer was formed to provide residential insurance and participate in the JUA takeout program. The taxpayer reported bonuses received from the JUA as nonshareholder contributions that were excluded under § 118. Following an "intent of the contributor test" that it derived from case law, the court found that the Florida legislature intended the takeout bonuses to constitute a nonshareholder contribution to capital and excluded the payments from income under § 118.

- The case did not discuss the treatment of the contributed capital under § 362(c).

2. **But this claim of a tax-free contribution to capital goes down in flames.** AT&T, Inc. v. United States, 623 F.3d 505 (5th Cir. 1/3/11), *aff'g* 104 A.F.T.R.2d 2009-6036 (W.D. Tex. 7/16/09). The Court of Appeals ((Judge Dennis) affirmed a District Court decision holding that payments from the Federal government for universal telephone access are includible in income, and are not excluded under § 118 as contributions to capital. The payments were part of state and federally mandated programs funded by fees collected from telecommunications carriers based on revenues. Payments are made to carriers with high cost obligations to provide universal access to telephone services. The District Court followed the decision in United States v. Coastal Utilities, Inc., 514 F.3d 1184 (11th Cir. 2008). The court traced the history of the exclusion for contributions to the capital of a corporation, ending with the five characteristics of a nonshareholder contribution to capital set forth in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973).

[1] It certainly must become a permanent part of the transferee's working capital structure. [2] It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. [3] It must be bargained for. [4] The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. And [5] the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

- From the Supreme Court jurisprudence, the court derived "three principles."

(1) Whether a payment to a corporation by a non-shareholder is income or a capital contribution is controlled by the intention or motive of the transferor. (2) When the transferor is a governmental entity, its intent may be manifested by the laws or regulations that authorize and effectuate its payment to the corporation. (3) Also, a court can determine that a transfer was not a capital contribution if it does not possess each of the first four, and ordinarily the fifth, characteristics of capital contributions that the Supreme Court distilled from its jurisprudence in CB&Q.

- Applying these principles to the facts of the case, the court concluded that, "either by construing the controlling statutes and regulations or by applying the CB&Q five-factor test, the governmental entities in making universal service payments to AT&T

did not intend to make capital contributions to AT&T; and thus, that the payments were income to AT&T.” Under the statutes authorizing the payments, the administrative implementation in regulations, the payments “were not intended to be capital contributions to AT&T, but to be supplements to AT&T’s gross income to enable it to provide universal service programs while meeting competition ... .” The payments “were compensation to AT&T for the specific and quantifiable services it performed for high-cost and lower-income users as well as for developing and maintaining universal service ... .” Furthermore, the payments did not become “a permanent part of AT&T’s working capital structure, as is demanded by the first *CB&Q* requirement.”

a. **And the beat goes on. Sprint Nextel Corporation v. United States**, 107 A.F.T.R.2d 2011-1204, (D. Kan. 3/04/2011). Payments from the FCC high cost program to make available communications services in high cost areas are not excluded nonshareholder contributions to capital.

3. Rev. Proc. 2011-30, 2011-21 I.R.B. 802 (4/14/11). The IRS will not challenge a corporate taxpayer’s treatment of an award from the Department of Energy under various programs for clean coal energy and carbon recapture, CCPI - Round 3, ICCS, or FutureGen 2.0, as a nonshareholder contribution to the capital of the corporation under § 118(a) of the Code if the corporate taxpayer properly reduces the basis of its property under § 362(c)(2) and the regulations.

4. **Transparent insolvency for disregarded entities. REG-154159-09**, Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 76 F.R. 20593 (4/13/11). Prop. Reg. § 1.108-9 would provide that, for purposes of applying § 108(a)(1)(A) and (B), the bankruptcy and insolvency exclusions, to discharge of indebtedness income of a grantor trust or a disregarded entity, the term taxpayer, as used in § 108(a)(1) and (d)(1) through (3), refers to the owner(s) of the grantor trust or disregarded entity.

5. **Mr. Wood’s stealing from his employer for the benefit of Woodie’s Market, Inc. is income to Wood. Wood v. Commissioner**, T.C. Memo. 2011-190 (8/10/11). Mr. Wood embezzled funds from the overhead door company where he was general manager and used the money for personal expenses and operating money for Woodie’s Market, Inc., owned and operated by Wood and his wife. The court (Judge Goeke) rejected the taxpayer’s assertion that because checks were written on the overhead door company account to Woodie’s Market the income was taxable to the Market rather than taxpayer personally. The court concluded that because the taxpayer had control over the funds and determined their use, the embezzled money was includable in the taxpayer’s gross income. The court pointed out that the taxpayer confused how the money was spent with how the money was acquired. The court also rejected the taxpayer’s argument that the embezzled funds were a contribution to capital of the Market. Using stolen funds as a contribution to capital does not relieve the taxpayers of their liability to report the income.

## B. Deductible Expenses versus Capitalization

1. **Those fancy Pyrex® and Oneida® branded kitchen products are made by Robinson Knife Manufacturing, which is required to capitalize license fees. Robinson Knife Manufacturing Co. v. Commissioner**, T.C. Memo. 2009-9 (1/14/09). The taxpayer designs and produces kitchen tools for sale to large retail chains. To enhance its marketing, the taxpayer paid license fees to Corning for use of the Pyrex trademark and Oneida for use of the Oneida trademark on kitchen tools designed and produced by the taxpayer. The taxpayer’s production of kitchen tools bearing the licensed trademarks was subject to review and quality control by Corning or Oneida. The IRS asserted that the taxpayer’s licensing fees were subject to capitalization into inventory under § 263A under Reg. § 1.263A-1(e)(3)(ii)(u), which expressly includes licensing and franchise fees as indirect costs that must be allocated to produced property. Agreeing with the IRS, the court (Judge Marvel) rejected the taxpayer’s argument that the licensing fees, incurred to enhance the marketability of its produced products, were deductible as marketing, selling, or advertising costs excluded from the capitalization requirements by Reg. § 1.263A-1(e)(3)(iii)(A). The court noted that the design approval and

quality control elements of the licensing agreements benefited the taxpayer in the development and production of kitchen tools marketed with the licensed trademarks. The court rejected the taxpayer's argument that Rev. Rul. 2000-4, 2000-1 C.B. 331, which allowed a current deduction for costs incurred in obtaining ISO 9000 certification as an assurance of quality processes in providing goods and services, was applicable to the quality control element of the license agreements. The court noted that although the trademarks permitted the taxpayer to produce kitchen tools that were more marketable than the taxpayer's other products, the royalties directly benefited and/or were incurred by reason of the taxpayer's production activities. The court also upheld the IRS's application of the simplified production method of Reg. § 1.263A-2(b) to allocate the license fees between cost of goods sold and ending inventory as consistent with the taxpayer's use of the simplified production method for allocating other indirect costs.

a. **But the Second Circuit disagrees.** Robinson Knife Manufacturing Co. v. Commissioner, 600 F.3d 121 (2d Cir. 3/16/10). Like the Tax Court, the Court of Appeals rejected Robinson's arguments that the royalty payments were deductible as marketing, selling, advertising or distribution costs under Reg. § 1.263-1(e)(3)(iii)(A), or that the royalty payments were deductible as not having been incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced under Reg. § 1.263A-1(e)(3)(ii)(U). The Court of Appeals concluded, however, that "royalty payments which are (1) calculated as a percentage of sales revenue from certain inventory, and (2) incurred only upon sale of such inventory, are not required to be capitalized under the § 263A regulations." The court held that the royalties were neither incurred in, nor directly benefited, the performance of production activities under Reg. § 1.263A-1(e)(3)(i). Unlike license agreements, the court concluded that Robinson could have manufactured the products, and did, without paying the royalty costs. The royalties were not, therefore, incurred by reason of the production process. The court also concluded that since the royalties were incurred for kitchen tools that have been sold, "it is necessarily true that the royalty costs and the income from sale of the inventory items are incurred simultaneously." The court noted further that had Robinson's licensing agreements provided for non-sales based royalties, then capitalization would have been required.

b. **Proposed regulations make you wonder why the IRS ever litigated *Robinson Knife*.** REG-149335-08, Sales-Based Royalties and Vendor Allowances, 75 F.R. 78940 (12/17/10). The IRS has proposed regulations under § 263A that generally provide the taxpayer-favorable result reached by the Second Circuit in *Robinson Knife*. The proposed regulations provide that sales-based royalties must be capitalized, but also provide that sales-based royalties required to be capitalized are allocable only to property that a taxpayer has sold, rather to closing inventory. The preamble asserts that the Second Circuit in *Robinson Knife* misconstrued the nature of costs required to be capitalized and that the costs of securing rights to use intellectual property directly benefits or are incurred by reason of production processes requiring that the costs be capitalized even if payable only on the basis of the number or units sold or as a percentage of revenue. Nonetheless, the proposed regulations are consistent with the holding of *Robinson Knife* where they provide that sales based royalties are related only to units that are sold during the taxable year. Thus, Prop. Reg. § 1.263A-3(d)(3)(i)(C)(3) would provide that sales based costs would not be included in ending inventory under § 471.

- However, in light of the generous treatment of sales-based royalties, the proposed § 263A regulations, along with proposed amendments to Reg. § 1.471-3(e), require that sales-based vendor allowances [which are rebates or discounts from a vendor as a result of selling the vendor's merchandise] must be taken into account as an adjustment to the cost of merchandise sold, effectively requiring that such allowances be included in gross income immediately, and would not be taken into account in ending inventory.

- The formulas allocating additional indirect costs to ending inventory under the simplified production and resale methods would be modified to remove capitalized sales based royalties and vendor allowances allocable to property that has been sold.

c. **But the IRS still disagrees with the Second Circuit.** AOD 2011-01, 2011-9 I.R.B. 526 (2/9/11), *corrected by* Ann. 2011-32, 2011-22 I.R.B. 836 (5/31/11). The

IRS disagrees with the Second Circuit analysis stating that the court “confused the timing with the purpose of the payments.” The IRS opines that Robinson incurred the royalty expenses first to produce then to sell the trade-marked items, adding that in order to sell the items it first had to produce them.

2. **Starting-up is cheaper.** The Small Business Jobs Act of 2010 increases the amount of deductible § 195 start-up expenses for investigating or creating an active trade or business from \$5,000 to \$10,000 for expenses incurred in a year beginning in 2010. The phase out amount is also increased from \$50,000 to \$60,000.

a. **Start-up and organization expenses final regulations are adopted.** T.D. 9542, Elections Regarding Start-up Expenditures, Corporation Organizational Expenditures, and Partnership Organizational Expenses, 76 F.R. 50887 (8/17/11). Sections 195 (start-up expenditures in an active trade or business), 248 (corporate organization expenditures), and 709 (partnership organization expenditures), each provide for an election to deduct such expenditures in the year business begins to the extent of the lesser of the amount of the expenditures or \$5,000 reduced by the amount that the expenditures exceed \$50,000. Under the election the remainder of the expenses are amortizable over 180 months beginning with the month that business commences. The finalized regulations, Reg. §§ 1.195-1, 1.248-1, and 1.709-1, following temporary and proposed regulations, provide that a taxpayer is deemed to make the election to amortize start-up or organization expenses for the year in which the active business, corporate business, or partnership business to which the expenditure relates begins. The regulations provide that a taxpayer may choose to forego the election by affirmatively electing to capitalize the expenditures on a timely filed return for the year in which the business begins. The final regulations are effective on the date of filing in the Federal Register, but may be applied by taxpayers to expenditures incurred after 10/22/04, provided the period for assessing a deficiency for the year the election is deemed made is still open.

3. **A retail safe harbor for car dealers.** Rev. Proc. 2010-44, 2010-49 I.R.B. 811 (11/9/10). Section 263A(a) and Reg. § 1.263A-3(c) require a taxpayer who acquires property for resale to capitalize acquisition costs and other costs allocable to the property, including purchasing, handling, and storage costs. However, a reseller is not required to capitalize handling and storage costs incurred at a retail sales facility. Under the safe harbor, a motor vehicle dealership may treat its entire sales facility from which it normally and routinely conducts on-site sales to retail customers, including any vehicle lot that is an integral part of its sales facility and that is routinely visited by retail customers, as a retail sales facility with respect to which the dealership is not required to capitalize handling and storage costs. A motor vehicle dealer without production activities may treat itself as a reseller under the Revenue Procedure. The costs of handling activities with respect to services performed on dealership owned vehicles and customer owned vehicles, other than the cost of parts, are not required to be capitalized. Parts used in dealer-owned vehicles must be capitalized as acquisition cost of its vehicles. A motor vehicle dealership using the “reseller without production activities safe harbor method” may use the “simplified resale method” under § 1.263A-3(d) for its vehicles and other eligible property. Adoption of the safe harbor is a change of accounting method subject to the automatic change in method under Rev. Proc. 2008-52, 2008-2 C.B. 587.

4. The Compromise Tax Relief Act of 2010, § 744, extends the election under Code § 181 to expense up to \$15 million qualified film and television production costs incurred in low-income or distressed communities through 2011.

5. **The § 198 deduction is extended through 2011.** The Compromise Tax Relief Act of 2010, § 745, extends the deduction under Code § 198 of otherwise capitalized environmental remediation expenses incurred to abate or control hazardous substances at a qualified environmental site through 2011. Otherwise, deductibility requires that the same taxpayer “messed up” the property and that the remediation expenses do not make the property suitable for a different type of use.

6. **Avoided interest attributable to associated property taken out of service requires capitalization under Chevron-tested regulations that barely survive.** Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239 (2/25/11). The taxpayer, an electric

utility, removed boilers from service to replace burners. Reg. § 1.263A-11(e)(1)(ii)(B) requires that the capitalized cost of improvements under § 263A include both direct expenditures and the capitalized cost of interest (under the avoided cost rules) attributable to the basis of property temporarily removed from service in order to complete the improvements. The court (Judge Lettow) rejected the taxpayer's arguments that (1) the associated property rule of Reg. § 1.263A-11(e)(1)(ii)(B) is invalid as inconsistent with § 263A, and (2) it was adopted in contravention of the requirements of the Administrative Procedure Act. Under the test of *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the taxpayer argued that the regulation was inconsistent with § 263A(f)(2)(A)(ii), which provides that for purposes of determining production period interest "with respect to any property . . . interest on any . . . indebtedness [not directly attributable to production expenditures] shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures . . . had not been incurred." The taxpayer asserted that "property" for this purpose under the statutory language can include only the improvement itself, which is separately depreciable, and cannot, therefore be expanded to include associated property as provided in the regulation. The taxpayer also argued that the production costs were incurred with respect to the replacement burners, and not with respect to the boilers themselves. While the court was not completely happy with the IRS argument that the property can be separated for depreciation purposes while considered as a unit for purposes of the interest allocation, the court concluded that the statute was sufficiently ambiguous under the first prong of the *Chevron* test, that the regulation could be tested under the second prong of *Chevron*, which asks whether the regulation is a permissible construction of the statute. Here the court indicated that, "It is stretching the statute quite far to say that the associated-property rule 'is a reasonable interpretation' of the enacted text [of section 263A]." The court added that the IRS's rationales "are not very satisfying." The court then concluded, however, that "it is not this court's province to be making such policy choices. In this very close case, the court cannot say that Treasury overstepped the latitude granted by the statute to adopt regulations prescribing the calculation of interest to be capitalized in connection with an improvement to existing property used by the taxpayer to produce income" and held that the regulation therefore survived the taxpayer's challenge. With respect to the taxpayer's challenge under the Administrative Procedure Act, the court again found that "it is a stretch to conclude that Treasury 'cogently explain[ed] why it has exercised its discretion in a given manner,'" but added that "[t]he 'path' that Treasury was taking in the rulemaking proceedings can be 'discerned,' albeit somewhat murkily" and upheld the regulation. Finally, the court rejected retroactive application of a de minimis rule of Reg. § 1.263A-11(e)(2) to the taxpayer, and denied the IRS counterclaim for capitalization of additional interest.

- No pretzel in existence has as many twists and bends as does this opinion. For background, see *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), at XI.A., below.

7. **Amounts paid that are contingent on successfully closing a transaction could be 70 percent deductible and 30 percent capitalizable.** Rev. Proc. 2011-29, 2011-18 I.R.B. 746 (4/8/11). Reg. § 1.263(a)-5 requires a taxpayer to capitalize any amount paid to facilitate a business acquisition, which includes any amount paid to investigate or pursue the acquisition. An amount contingent on successfully closing a transaction is presumed to facilitate the transaction. The revenue procedure indicates that the IRS will not challenge the allocation of success based fees if the taxpayer treats 70 percent of the fee as an amount that does not facilitate the transaction, capitalizes the remaining 30 percent of the fee as an amount that does facilitate the transaction, and attaches a statement to the return for the year indicating that the taxpayer is electing the safe harbor.

- The IRS seems to be giving up a lot in order to avoid these types of controversies.

8. **Housing construction on unimproved lots is production.** Gardner v. Commissioner, T.C. Memo. 2011-137 (6/20/11). The taxpayer was a self-employed contractor who built single and multiple family housing on unimproved land that he purchased. The Tax Court (Judge Halpern) held that the taxpayer was required to capitalize engineering costs and

taxes incurred in connection with a 34 acre parcel that the taxpayer prepared for subdivision then sold. The court concluded that the parcel was held for production, and § 263A requires capitalization of pre-production costs with respect to property held for construction or improvement. See § 263A(g)(1) and Reg. § 1.263A-2(a)(3)(ii). However, because no physical production had occurred during the year, the rule of § 263A(f), requiring capitalization of production period interest, did not apply to require capitalization of interest, so the interest was deductible. The court also held that the sale of three subdivided/duplex lots resulted in short-term capital gain. The court found that, although the taxpayer regularly purchased undeveloped land for development and sale, the taxpayer held some properties with the intent of developing the property and holding it for rent rather than for sale to customers.

9. **Final regulations come out just in time for the expiration date of the statute.** T.D. 9551, Deduction for Qualified Film and Television Production Costs, \_\_\_ I.R.B. \_\_\_ (9/30/11). Section 181 provides for an election to deduct qualified film or television production costs incurred in productions commenced prior to 1/1/12, as an expense not chargeable to capital account in an amount up to \$15 million for each production, or \$20 million for production expenses incurred in certain low income or distressed county areas. A production qualifies for the election of at least 75 percent of the total compensation for the production is for services performed in the United States by actors, directors, producers, and production personnel. Final regulations §§ 1.181-1 through -6, replacing temporary and proposed regulations, clarify the owner of production costs, the definition of aggregate production costs for purposes of the election and limitations, and provisions applicable to participations and residuals.

### C. Reasonable Compensation

1. **Throwing the TARP over compensation of insurance executives even though they never received a TARP.** The 2010 Health Care Act amended § 162(m) by adding subsection (m)(6) to limit deductions for compensation paid by health insurance providers, which is defined as any employer that is a health insurance issuer (as defined in § 9832(b)(2) of the Act) not less than 25 percent of the gross premiums of which are received from providing health insurance coverage (as defined in § 9832(b)(1) of the Act) “that is minimum essential coverage.” The deduction for compensation for services rendered in any year is limited to \$500,000, regardless of whether the compensation is paid during the taxable year or in a subsequent taxable year. As under § 162(m)(5) for remuneration from TARP participants, there are no exceptions for performance based compensation or compensation under existing binding contracts. The limitation applies not only to all officers, directors, and employees, but also to any other service providers, such as consultants, performing services for or on behalf of a covered health insurance provider. The provision is effective for remuneration paid in taxable years beginning after 2012 with respect to services performed after 2009.

• **OMG — Does it apply to outside counsel? Probably not.**

a. **Thank God! The legal fees are safe.** Notice 2011-2, 2011-2 I.R.B. 260 (12/23/10). The § 162(m)(6) limitation applies to remuneration for services performed in a “disqualified taxable year” beginning after 12/31/12 that is otherwise deductible by a covered health insurance provider in a taxable year beginning after 12/31/12. It also applies to deferred deduction remuneration attributable to services performed in a taxable year beginning after 12/31/09 and before 1/1/13 if the employer was a pre-2013 covered health insurance provider for the year in which services were performed and the employer is a post-2012 covered health insurance provider for the year in which the deferred deduction remuneration is otherwise deductible. The guidance also has a de minimis rule, as well as a definition of “applicable individual” that excludes an independent contractor who provides substantial services to “multiple unrelated customers.”

2. **Every time a reasonable compensation case is appealable to the Seventh Circuit, it seems that whoever judge is, after doing the *Exacto* bit to satisfy Judge Posner, he or she adds something like, “and in any event it wasn’t deductible because it wasn’t intended to be compensation.”** Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, T.C. Memo. 2011-74 (3/31/11). The taxpayer, an accounting and consulting firm operating as a



C corporation, made payments to three related entities owned by the three named principals of the corporation that essentially resulted in zeroing out the taxpayer's income for the year. The related entities performed no services for the taxpayer, and at trial the taxpayer claimed that the payments were deductible as compensation to the named principals, who did perform services for the taxpayer. The court (Judge Morrison) held that even if the payments were viewed as compensation to the named principals, the payments were not deductible. Applying the "hypothetical independent investor" test of *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (1999), because the case was appealable to the Seventh Circuit, Judge Morrison found that the rate of return on the firm's equity was "too low to create a presumption that the amounts claimed as 'consulting fees' were reasonable compensation for the [principals'] services." Because the taxpayer presented no other relevant evidence that the payments were reasonable in amount, the deduction was disallowed. Judge Morrison added that besides being reasonable in amount, to be deductible the payment must be intended to be compensation, and the payments in question were not intended to be compensation.

[The firm] intended for the payments to the related entities to distribute profits, not to compensate for services. ... Salvador chose the amount to pay each year so that the payments distributed all (or nearly all) accumulated profit for the year. He did this for tax planning purposes. Each [principal's] percentage of the payments to the related entities was tied to hours worked, but the firm's intent in making the payments was to eliminate all taxable income. The firm did not intend to compensate for services.

• Accuracy related penalties were upheld, with Judge Morrison taking special note of the fact that the taxpayer was an accounting firm.

**3. Non-limit limitations on excessive compensation to corporate officers.** Reg.-137125-08, Certain Employee Remuneration in Excess of \$1,000,000 Under Section 162(m), 76 F.R. 37034 (6/24/11). Section 162(m) limits deduction for compensation to top corporate officers of publicly traded corporations to \$1 million with an exception to performance based compensation attributable to stock options and stock appreciation rights. Proposed regulations § 1.162-27(e)(2)(iv) would require that performance based compensation plans designate the maximum number of share with respect to which options or rights may be granted to an individual employee during a specified period. The preamble to the proposed regulations indicates that the IRS rejects assertions that specifying a limit is not necessary because such plans require shareholder approval as contrary to its interpretation of legislative history as requiring an objective formula for determining the maximum amount of compensation an employee could receive is the employee's performance goal is met.

#### **D. Miscellaneous Deductions**

**1. Standard mileage rate rules published in a revenue procedure while the amounts will be disclosed in a separate notice.** Rev. Proc. 2010-51, 2010-51 I.R.B. 883 (12/3/10). The IRS indicated that beginning in 2011 it will publish mileage rates in a separate annual notice. The revenue procedure indicated that a taxpayer may use the business standard mileage rate to substantiate expenses for business use of an automobile in lieu of fixed and variable costs. Parking fees and tolls are deductible as separate items. The basis of an automobile used for business is reduced by a per-mile amount published in the annual notice. Separate rates are provided both for charitable use of an automobile and medical and moving use of an automobile. The revenue procedure also provides details for treating as substantiated a fixed and variable rate allowance for expenses incurred by an employee in driving an automobile owned or leased by the employee in performing services for the employer.

**a. Standard mileage rates announced.** Notice 2010-88, 2010-51 I.R.B. 882 (12/3/10). Standard mileage rates for 2011 are: (1) 51 cents per mile for business miles driven [up from 50 cents]; (2) 19 cents per mile driven for medical or moving purposes [up from 16.5 cents]; and (3) 14 cents per mile driven in service of charitable organizations [unchanged because the rate is statutory, § 170(i)].

**b. Mileage rates are back up for second half of 2011.** Ann. 2011-40, 2011-29 I.R.B. 56 (6/23/11). The IRS has announced that the standard optional mileage rates for computing the deductible costs of operating an automobile for business will increase from 7/1/11 through 12/31/11 to 55.5 cents per mile. The standard rate for purposes of medical and moving expenses is 23.5 cents per mile. The statutory rate for charitable deductions purposes is 14 cents per mile.

**2. Have you documented that your own cell phone is used for business rather than personal purposes?** Tash v. Commissioner, T.C. Memo. 2008-120 (4/29/08). Among the many deductions claimed by a lawyer that Judge Haines disallowed was the deduction claimed for his cellular telephone, because “[t]he record did not indicate whether petitioner used his cellular telephone for business and/or personal calls.” Inasmuch as cell phones are listed property, Reg. § 1.274-5(c) and (f) require substantiation for the deduction.

**a. How do you steer the car? It might or might not be OK to drive while talking on your cell phone, but it is imperative to take notes in your log book while chatting on the phone.** Alami v. Commissioner, T.C. Memo. 2009-42 (2/23/09). Judge Vasquez denied the taxpayer’s claimed business deductions for cellular telephone service because the taxpayer failed to establish the amount of time he used his cell phone for business and personal purposes. A cellular phone is “listed property” that is subject to the strict substantiation requirements of § 274(d) pursuant to § 280F(d)(4)(A)(v), and a taxpayer must establish the amount of business use and the amount of total use for the property to substantiate the amount of expenses for listed property. An alternative ground for denying the deduction was that the taxpayer’s employer did not require that he have a cell phone.

- Query whether there are employer reporting obligations with respect to cell phones furnished to employees who fail to keep records?

**b. But, simplified methods for reporting cell phone use are under consideration.** Notice 2009-46, 2009-23 I.R.B. 1068 (6/8/09). IRS is considering methods to simplify treatment of employer-provided cell phones, including a (1) “minimal personal use method” (if the employee accounts to the employer that he has a personal cell phone for use during business hours); and (2) a safe harbor method under which an employer would treat 75 percent of each employee’s use of the cell phone as business usage.

- In a letter to Representative Skelton, INFO 2009-0141 (7/8/09), the IRS advised that it is seeking clarifying legislation from Congress. 2009 TNT 216-62.

**c. And the Prez says to Congress “delist” cell phones.** President Obama’s Fiscal Year 2011 Budget calls for Congress to amend § 280F to remove cellular telephones from the category of listed property, thereby “effectively removing the requirement of strict substantiation and the limitation on depreciation deductions.” Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals 26 (February 2010). The substantiation requirements are “burdensome for employers”; it is difficult to document the cost of cell phone calls, and “the cost of accounting for personal use often exceeds the amount of any resulting income.” The proposal specifically contemplates that “a cell phone (or other similar telecommunications equipment) provided primarily for business purposes would be excluded from gross income.”

**d. Finally, there is no longer a need to keep a log book on the front seat of your car.** Section 2043 of the Small Business Jobs Act of 2010 removed “cellular telephones and similar telecommunications equipment” from the definition of “listed property” contained in § 280F(d)(4) for taxable years beginning after 12/31/09. This, in turn, eliminates the § 274(d) substantiation requirement for business cell phone use.

**e. ♪”Hanging on the [cellular] telephone.”♪ Notice 2011-72, 2011-38 I.R.B. 407** After 12/31/09, a cellular telephone provided to an employee for a substantial noncompensatory purpose is a working condition fringe benefit. The employer’s need to contact the employee at all times for work-related emergencies, the employer’s requirement that the employee be available to speak with clients at times when the employee is away from the office, and the employee’s need to speak with clients located in other time zones at times outside of the employee’s normal work day are possible substantial noncompensatory business reasons.

A cell phone provided to promote the morale or good will of an employee, to attract a prospective employee or as a means of furnishing additional compensation to an employee is not provided primarily for noncompensatory business purposes. If the provision of the phone qualifies as a working condition fringe benefit, the value of any personal use of an employer-provided cell phone can be excluded from income as a *de minimis* fringe benefit.

3. **The courts really socked it to this CPA. The legal fees he paid in connection with defending a criminal charge arising from his kissing a client's employee do not give rise to deductions in his accounting business.** Argyle v. Commissioner, 397 Fed. Appx. 823 (3d Cir. 10/14/10), *aff'g* T.C. Memo. 2009-218. In a non precedential per curiam opinion the court upheld the Tax Court's conclusion that a CPA could not deduct legal expenses incurred in a criminal simple assault case brought by the female employee of a client who the taxpayer kissed at her home. The court rejected the taxpayer's assertion that the criminal action was brought because he had reprimanded the woman for misconduct in the client's business and that the fees, therefore, arose out the CPA's professional activities. The court concluded that the origin of the criminal complaint was the taxpayer's personal activities. The court also upheld the Tax Court's finding that the taxpayer was not entitled to the claimed home office expense deductions.

4. **Non-salaried members of a religious organization are employees whose compensation is deductible by the tax-exempt organization.** Stahl v. United States, 626 F.3d 520 (9th Cir. (11/29/10)). The taxpayer was a member and president of the Stahl Hutterian Brethren (SHB), a § 501(d) religious or apostolic organization in which the members pooled their efforts in farming and selling produce. The organization paid no salaries but took care of the members' personal needs such as food, shelter, and medical care. The members did not contribute to or collect social security benefits. Under § 501(d) a religious or apostolic organization is exempt from tax if it maintains a common treasury and its members include in gross income their pro rata share of the entity income, whether or not distributed. The taxpayer claimed that he was an employee of SHB so that his medical and meal expenses were deductible in determining the entity's taxable income. Reversing summary judgment in the District Court, the court held that, applying the common law factors defining employment status, the members of SHB were employed by the business, even though they have many other relationships among themselves and to the organization.

5. **Holding herself out as a contract attorney did not establish a trade or business.** Forrest v. Commissioner, T.C. Memo. 2009-228 (10/5/09). Before 1988 the taxpayer worked as a contract attorney performing work for other attorneys. She then went to work for the California Department of Corporations, but was terminated from that position in 2000. She worked as a contract attorney in 2000, but not in 2001 and 2002. In 2003 the taxpayer attempted again to work as a contract attorney, incurring expenses, before she was reinstated with the Department of Corporations in 2003. The court (Judge Vasquez) held that the taxpayer's activities were not sufficiently regular or continuous to qualify as a trade or business. The court also concluded that, even if the taxpayer's prior activities were sufficient to qualify as a trade or business, there was insufficient continuity into her activities in 2003 to constitute a continuation of her previous trade or business. The court also noted that the taxpayer's attendance at a four day ABA meeting and attempts to solicit contract work were not regular and continuous business activities, that she did not negotiate or perform contract attorney services during the year, and that her efforts were terminated when she resumed employment with the Department of Corporations.

a. **The cost of figuring out what kind of work you're going to do isn't deductible.** Forrest v. Commissioner, T.C. Memo. 2011-4 (1/4/11). The court (Judge Wherry) held that expenses incurred in a "fledgling effort" solo law practice by a lawyer who reported no income from her law practice, but which were incurred to make contacts and network in an effort to "figure out what kind of work ... [the taxpayer] was going to do," were nondeductible start-up expenses under § 195.

6. **Appropriately-named television news anchor was denied a deduction for her wardrobe, etc.** Hamper v. Commissioner, T.C. Summary Opinion 2011-17 (2/24/11).

The court (Special Trial Judge Dean) denied a television news anchor's deduction of clothing costs and upkeep because the clothing in question was suitable for everyday wear, and held that taxpayer's claimed business deductions were personal expenses. Accuracy-related penalties were upheld.

7. **Let the judicial interpretation of § 199 begin! Gibson & Associates, Inc. v. Commissioner**, 136 T.C. No. 10 (2/24/11). Section 199 allows a corporate taxpayer to deduct a percentage (equal to 3 percent for the year in question) of its "qualified production activities income." The starting point for the computation is "domestic production gross receipts." Section 199(c)(4)(A)(ii) provides that domestic production gross receipts include a taxpayer's gross receipts from the construction of real property performed in the United States if the taxpayer is engaged in the active conduct of a construction business and the gross receipts are derived in the ordinary course of that business, but § 199 does not define the phrase "construction of real property." The taxpayer is an engineering and heavy construction company that primarily erects or rehabilitates streets, bridges, airport runways, and other related real property. Its rehabilitation services relate mainly to real property that is substantially dilapidated or damaged from a casualty. The taxpayer also repairs and maintains real property. The taxpayer treated all of its receipts as "domestic production gross receipts" eligible for the § 199 deduction, but the IRS disallowed the deduction on the ground that none of its receipts qualified. The Tax Court (Judge Paris) held that the receipts derived from the erection or substantial renovation of real property (that operated and performed a discrete function in and of itself) were domestic production gross receipts to the extent that the taxpayer's activities with respect to each property (1) materially increased the value of the real property, (2) substantially prolonged the useful life of the real property, and/or (3) adapted the real property to a different or new use. Many of the taxpayer's activities met this test. However, the gross receipts from the taxpayer's real property repair business that were unrelated to its primary business and which did not materially increase the value of the real property, substantially prolong its useful life, and/or adapt the real property to a different or new use did not qualify. The case was highly factual.

8. **Hard Rock Cafes are unified but not substantiated. Morton v. United States**, 107 A.F.T.R.2d 2011-1963 (Fed. Cl. 4/27/11). The taxpayer is one of the co-founders of the Hard Rock Café chain, which is operated through a series of S corporations in which the taxpayer was the sole or majority investor. In addition the taxpayer owned the real property underlying Hard Rock cafes, which was leased to the S corporations. The taxpayer travelled in a Gulfstream III aircraft, which he exchanged for a Gulfstream IV through a qualified intermediary. The aircraft was used both for business and personal travel. While the pilot logs for the aircraft recorded the date, time of the trips, destinations, and the number of passengers, the logs did not record the identity of passengers or the purpose of the trips. The court accepted the taxpayer's argument that the taxpayer's unified business enterprise permitted deductions for the aircraft use that furthered the business purpose of the taxpayer's various entities other than the entity to which the aircraft was registered. *Deputy v. du Pont*, 308 U.S. 488 (1940), and *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), held that the taxpayer and his corporations must be treated as separate entities for determining business expenses under § 162. The court concluded that, "Undisputed facts support the conclusion that Plaintiff's entities were intertwined and formed a unified business enterprise that operated for profit-making purposes." However, the court deferred ruling on the summary judgment motion on the deductibility of the expenses and depreciation pending indicating that its ruling would be dependent upon substantiation of business use of the aircraft.

- The court also held that a mistaken disbursement of cash to the taxpayer's corporation on the exchange of the Gulfstream III rather than to the qualified intermediary, when the money was immediately returned to the intermediary should not defeat like-kind exchange treatment under § 1031 because the error was quickly rectified.

- However, the court also deferred ruling on the § 1031 exchange pending a determination of the business use of the aircraft.

9. **Scroggins v. Commissioner**, T.C. Memo 2011-103 (5/18/11). The court (Judge Wherry) held that the taxpayer who maintained a residence in Georgia but worked in

California, was not entitled to away from home deductions for California expenses. The taxpayer was employed exclusively in California and he knew that he would be away from Georgia for a very long time. The taxpayer's employment as a medical technician was highly specialized as a type of work not available in Georgia. Finally, the taxpayer had no business reason for maintaining a home in Georgia.

**10. Day trading is a losing proposition, but it's not a trade or business.** Kay v. Commissioner, T.C. Memo 2011-159 (7/6/11). As the sole owner of a ball bearing manufacturing operation the taxpayer reported wages of \$36,400, \$43,600, and \$52,000 in tax years 2000, 2001, and 2002. The taxpayer's S corporation reported net income of \$657,683, \$385,270, and \$278,213 in those years. The taxpayer also claimed losses of \$2,052,637, \$399,740 and \$278,297 from sales of stocks in his day trading activities. In the years 2000, 2001, and 2002, the taxpayer executed 313, 172 and 84 trades respectively. The taxpayer rarely purchased and sold stocks on the same day. During the years at issue, the taxpayer conducted trading activity on 29 percent, 7 percent, and 8 percent of the available trading days. The Tax Court (Judge Cohen) held that, although the taxpayer's trading was substantial, the taxpayer's activities were not sufficiently frequent to be treated as a trade or business. The court noted that the taxpayer's S corporation was his primary source of income and rejected the taxpayer's claim that he spent the majority of his time in his trading activities. Thus the taxpayer's losses were capital losses, the deductions of which were limited to \$3,000 per year. The court also sustained penalties under § 6662.

**11. Deductible legal fees incurred in defending internet shoe sales.** Ramig v. Commissioner, T.C. Memo. 2011-147 (6/27/11). The taxpayer incurred legal expenses successfully defending an investor suit against a failed internet shoe store in which the taxpayer was the CEO and an investor. The Tax Court (Judge Morrison) agreed with the taxpayer's assertion that because he was sued personally, the legal claims originated out of the taxpayer's services for the company as an employee and allowed deductions under § 162. The court disallowed claimed bad debt deductions for advances that the taxpayer made to the company when it was unable to obtain external financing, holding that the advances were equity.

**12. The girlfriend's house is not a primary place of business.** Bogue v. Commissioner, TC Memo. 2011-164 (7/11/11). The taxpayer shared a home with his fiancée from which he travelled to various construction job worksites. The taxpayer stored tools at the residence, made business related phone calls, and used a computer to search for materials, but did not establish an exclusively used home office. The Tax Court (Judge Wells) denied deductions for travel between the residence and the worksites holding that under the judicial exception for travel expenses between a home and worksites requires that the residence constitute a principal place of business at which the taxpayer maintains a home office that meets the requirement of § 280A(c)(1) that the home office be used regularly and exclusively as the taxpayer's principal place of business. The court also denied deductions for travel from the taxpayer's residence in Cherry Hill, New Jersey to worksites in the Philadelphia area as travel to temporary distant worksites.

**13. What's a freeway flyer adjunct professor who teaches online courses? Why an employee, of course.** Schramm v. Commissioner, T.C. Memo. 2011-212 (8/30/11) The taxpayer was an adjunct professor at Nova Southern University (NSU) who taught online economics courses under separate contracts entered into for each course. NSU provided the syllabus for each course and specified the material that was to be covered. NSU filed forms W-2 for the taxpayer treating him as an employee. The court (Judge Ruwe) agreed with the IRS that the taxpayer was an employee and denied deductions for business expenses reported by the taxpayer on schedule C as an independent contractor. The court found an employment relationship under multiple factors, noting that even though the taxpayer's position as an adjunct professor allows an independent approach in teaching his classes, NSU had authority to exercise control in a manner that rendered the taxpayer an employee, the taxpayer's own investment in tools or facilities was insubstantial, the remuneration received by the taxpayer was not subject to fluctuation as independent profit or loss, the taxpayer did not demonstrate that he would be entitled to breach of contract damages if the relationship were terminated, the taxpayer was

engaged in NSU's regular business, the taxpayer maintained a continuing relationship with NSU over a period of years, and NSU considered the relationship to be an employer-employee relationship. The court indicated that the fact that NSU did not provide employment benefits, indicating an independent contractor status, carried little weight in the overall analysis.

**14. Farm spouse's medical reimbursement plan may be deductible if she is a common law employee.** Shellito v. Commissioner, 108 A.F.T.R.2d 2011-5952 (10th Cir. 8/24/11). The taxpayer conducted a farming operation in all of which he claimed a sole proprietary interest. The taxpayer's wife worked on the farm since 1982 assisting in planting and harvesting, operation of tractors, caring for livestock, repairing fences and equipment, handling books and records, and other tasks. The taxpayer claimed that he made all of the business and operating decisions without input or consent from his wife, whose work he directed. He did not regard his wife as a business partner and listed her occupation on their joint return as housewife. In 2001 the taxpayer adopted a medical reimbursement plan for employees and entered into an employment agreement with his wife that indicated that she was a hired farm hand to do farm work as the taxpayer directed. The Tax Court, T.C. Memo. 2010-41, sustained the IRS disallowance of the taxpayer's deductions on the couple's joint return for expenses of the medical reimbursement plan holding that the taxpayer's wife was not an employee because she was not compensated concluding that the wife was an equal owner of all funds paid into her individual account from the couple's joint checking account, that payment of her medical expenses was simply an assumption of her husband's liability under Kansas state law, and that the form of the transaction did not in substance give rise to a true employment relationship. In reversing the Tax Court, the Tenth Circuit reviewed numerous Tax Court memorandum and summary opinions to point out that the IRS position on a spouse as employee has been inconsistent. The court also referred to Rev. Rul. 71-588, 1971-2 C.B. 91, which provides that, "Amounts reimbursed under an accident and health plan covering all bona fide employees, including the owner's wife, and their families are not includable in the employee's gross income and are deductible by the owner as business expenses." The court rejected the IRS argument that the medical reimbursement should be disregarded because they convert a legal obligation to support into a deductible expense as not supported by any case law. The court also rejected the Tax Court's conclusion that the payments were not deductible because they were made from the couple's joint checking account noting that such a requirement would only add another structural layer to the holding of Rev. Rul. 71-588 providing for spousal employment. The court also noted that there was no proof that the funds in the joint checking account were equally owned by the spouses. The appellate court also rejected the Tax Court's "substance over form" holding by indicating that the Tax Court was incorrect in concluding that the taxpayer's wife worked for no compensation. Ultimately, the appellate court remanded the case for findings on the issue of whether the wife was an employee under the common law agency doctrine.

**15. It how you spend the loan proceeds, not what you pledge to secure the loan that determines deductibility of interest.** Sherrer v. Commissioner, T.C. Memo. 2011-198 (8/15/11). Under Temp. Reg. § 1.163-8T(c), the actual use of loan proceeds is generally determinative of the classification of the interest paid on the loan. Except in the case of qualified residence interest subject to § 163(h)(3), the absence or presence of a security interest is not relevant. Applying this rule, the Tax Court (Judge Carluzzo) held that interest paid by the taxpayer on loans secured by business property was not deductible as interest on trade or business indebtedness, because taxpayer failed to show that proceeds of the loans were used for business purposes. The interest on the loans was treated as nondeductible personal interest.

**16. Home may be a tax home.** Lyseng v. Commissioner, T.C. Memo. 2011-226 (9/21/11). The taxpayer was a contract laborer performing maintenance work on nuclear plants and other utilities. The taxpayer worked temporarily at job sites that required travel away from the taxpayer's residence in Northern Minnesota where he lived with his father and fiancé. Petitioner's jobs lasted less than one year, and most lasted only a few months. Petitioner sought work through his union located in his city of residence. The court (Judge Swift) indicated that "the taxpayer's home may be the tax home if, (1) The taxpayer incurs duplicate living expenses while traveling and maintaining the home; (2) the taxpayer has personal and historical

connections to the home; and (3) the taxpayer has a business justification for maintaining the home," citing *Hantzis v. Commissioner*, 638 F.2d 248, 255 (1st Cir. 1981). The court concluded that because the taxpayer's jobs were temporary he had no principal place of work, the taxpayer incurred duplicated expenses, and his home historically had been around the city of his residence. Thus, the court ruled that the taxpayer was entitled to claim deductions for his travel away from his place of residence. The court allowed some and denied some of the taxpayer's claimed deductions based on an evaluation of the substantiation provided by the taxpayer in accord with the strict requirements of § 274(d).

#### **E. Depreciation & Amortization**

**1. Now that's a whole lotta expens'n goin' on!** For taxable years beginning in 2008 and 2009, the 2009 ARRA, § 1202, increases the § 179 maximum deductible amount to \$250,000 and provides a phase-out threshold of \$800,000. The maximum amount allowed to be deducted under § 179 is increased by another \$35,000 for (a) qualified enterprise zone property, I.R.C. § 1397(a)(1), and (b) qualified renewal community property acquired and placed in service after 2001 and before 2010. I.R.C. § 1400J. In addition, for both qualified enterprise zone property and qualified renewal community property, only fifty percent of the cost of property in excess of the threshold for the phase-out is taken into account. I.R.C. § 1397(a)(2). Section 179(e) increases the maximum amount allowed to be deducted under § 179 by \$100,000, and increases the phase-out threshold by \$600,000, for qualified disaster assistance property placed in service after 2007 (with respect to disasters declared after that date) and before 2010. The increased expensing and ceiling limits under the 2009 ARRA also affect the special expensing rules for enterprise zone property, renewal property, and for qualified disaster assistance property. Thus, the maximum § 179 deduction for qualified enterprise zone and renewal property is \$285,000 for 2008 and 2009 (\$250,000 + \$35,000). For qualified disaster assistance property in 2008 and 2009 the maximum deduction is \$350,000 (\$250,000 + \$100,000), and the phase-out threshold is \$1,400,000 (\$800,000 + \$600,000).

**a. And the tide of the expens'n rolls on.** The 2010 HIRE Act extended the increased \$250,000 ceiling on deducting the cost of equipment under § 179, and the increased phase-out threshold of \$800,000, through taxable years beginning before 2011.

**b.** Rev. Proc. 2010-24, 2010-25 I.R.B. 764 (6/1/10). The Revenue Procedure modifies Rev. Proc. 2009-50, 2009-45 I.R.B. 617, § 3.08, to update inflation adjusted § 179 first year depreciation to reflect increases provided by the 2010 HIRE Act increasing for taxable years beginning in 2010 the aggregate cost of § 179 property eligible for expensing to \$250,000 and the amount above which the deduction is reduced to \$800,000. After the Small Business Jobs Act of 2010 increased the § 179 deductible amount to \$500,000 for tax years beginning in 2010 and 2011, Rev. Proc. 2010-24 became irrelevant.

**c. The tide is growing into a tsunami.** The Small Business Jobs Act of 2010 increases the § 179 increased the deductible amount to \$500,000 for tax years beginning in 2010 or 2011 and increases the phase-out threshold to \$2,000,000.

**d. And certain real property becomes eligible.** The Small Business Jobs Act of 2010 extended the § 179 deduction to "qualified real property" as defined in § 168(e). Section 179(f) allows the deduction of up to \$250,000 of capital expenditures for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The qualified real property allowance is within the overall \$500,000 expenditure limit of § 179 and is limited to depreciable real property used in the taxpayer's trade or business.

**e. Section 179 limits are extended again – is this becoming permanent like research credits?** The Compromise Tax Relief Act of 2010, § 402, provides for Code § 179 first year expensing for tax years beginning in 2012 in an amount not to exceed \$125,000 with a phase-out amount beginning at \$500,000. For tax years beginning after 2012 the maximum deduction drops to \$25,000 with the phase-out beginning at \$200,000 (at least until the business community makes sufficient campaign contributions to extend the higher numbers into later years).

f. **And applied to computer software for another year.** The Compromise Tax Relief Act of 2010, § 402, extends eligibility as qualified Code § 179 property to off-the-shelf computer software placed in service before 2013.

2. **Fifty percent bonus depreciation is extended for 2010.** The Small Business Jobs Act of 2010 extends application of the 50 percent bonus depreciation allowance of § 168(k) for one year to property placed in service before 1/1/11. The 50 percent allowance is available for depreciable machinery and equipment and most other tangible personal property, and is available for computer software and certain leasehold improvements, the first use of which began with the taxpayer.

a. **But why worry about § 179 with bonus depreciation at 100% extended for 2011.** The Compromise Tax Relief Act of 2010, § 401, increases first year bonus depreciation under Code § 168(k) to 100% of the cost of qualified property placed in service after 9/8/10, and before 1/1/12.

3. **That light weight crossover SUV might get caught by § 280F, but that ridiculously expensive heavyweight SUV is fully deductible under § 168(k).** Rev. Proc. 2011-21, 2011-12 I.R.B. 569 (3/18/11), *amplifying and modifying* Rev. Proc. 2010-18, 1010-9 I.R.B. 427. For automobiles placed in service in 2011 that qualify as § 168(k) property, the § 280F ceilings on depreciation deductions are \$11,060 for the first year, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for each succeeding year. For light trucks or vans placed in service in 2011 that qualify as § 168(k) property, the limits are \$11,260 for the first year, \$5,200 for the second year, \$3,150 for the third year, and \$1,875 for each succeeding year. For automobiles placed in service in 2011 that do not qualify as § 168(k) property, the limits are \$3,060 for the first year, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for each succeeding year. For light trucks or vans placed in service in 2011 that do not qualify as § 168(k) property, the limits are \$3,260 for the first year, \$5,200 for the second year, \$3,150 for the third year, and \$1,875 for each succeeding year.

a. **The IRS identifies property eligible for 100 percent depreciation, including the unintended consequences for business autos.** Rev. Proc. 2011-26, 2011-16 I.R.B. 664 (3/29/11). 2010 tax acts extended the placed in service date for property to be eligible for the § 168(k)(1) 50 percent first year depreciation allowance to property placed in service before 2013 (2014 in the case of certain property described in § 168(k)(2)(B) and (C)) and adopted § 168(k)(5) to allow a 100 percent depreciation deduction for qualified property acquired after 9/8/10 and before 1/1/12, and placed in service before 1/1/12. The revenue procedure sets out several rules for the application of these provisions.

- Reg. § 1.168(k)-1(b)(4)(iii)(C)(1) and (2) provide that if the larger part of self-constructed property commences before the applicable dates for the 50 percent depreciation deduction, components self-constructed after the effective date are also ineligible for the accelerated deduction. If the construction of the larger part of self constructed property begins before 9/9/10, but the qualified property otherwise qualifies for the 50 percent depreciation deduction, self-constructed components after 9/9/10, that are qualified property may be subject to an election to claim 100 percent depreciation deductions with respect to the component.

- Section 168(k)(2)(D)(iii) provides an election not to claim first year depreciation with respect to a “class of property” placed in service during the taxable year. Reg. § 1.168(k)-1(e)(2)(i) applies the election to each class of property described in § 168(e). The revenue procedure allows an election to claim 50 percent first year depreciation rather than 100 percent depreciation for a class of property.

- **The passenger automobile anomaly.** The additional first year depreciation allowance is limited to \$8,000 for passenger automobiles and light trucks subject to the § 280F limitations (\$3,060, \$4,900, \$2,950 in years one through three respectively, and \$1,775 in years four through six). Thus the first year depreciation allowance in year one is \$11,060 (\$3,060 plus \$8,000). This allowance is treated as the 100 percent depreciation deduction. Under § 280F(a)(1)(B)(i), unrecovered passenger automobile basis is treated as a deductible expense (up to \$1,775) in each year after the sixth year. Unless the taxpayer elects to forego 100 percent depreciation recovery with respect to a passenger automobile, the taxpayer would be treated as



claiming 100 percent depreciation in year one, with no further deductions allowable in years two through six. The revenue procedure provides a safe harbor method of accounting that the taxpayer is deemed to apply by deducting depreciation of the passenger automobile for the first taxable year succeeding the placed in service year. In effect, the revenue procedure continues to treat passenger automobile and light truck depreciation as if the first year deduction were 50 percent depreciation.

4. **Certain real property is 15 year MACRS property.** The Compromise Tax Relief Act of 2010, § 737, extends application of Code § 168(e)(3)(E and (e)(8)(E), which allow 15 years MACRS recovery for certain qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, to property placed in service on or before 12/31/11.

5. **NASCAR wins again.** The Compromise Tax Relief Act of 2010, § 738, extends the 7-year cost recovery period for real property improvements at motor-sports facilities under Code § 168(i)(15)(D) to property placed in service before 1/1/12.

6. **Oral leases don't cut it if you want a § 179 deduction for the leased property.** Thomann v. Commissioner, T.C. Memo. 2010-241 (11/1/10). Pursuant to § 179(d)(5)(B), a taxpayer (other than a corporation) who leases property to others may not deduct the cost of the leased property under § 179 unless the taxpayer meets a two-prong test: (1) the term of the lease, taking into account options to renew, must be less than 50 percent of the class life of the leased property, and (2) the taxpayer's § 162 business expenses for the leased property during the initial 12-month period following the transfer of the property to the lessee must exceed 15 percent of the rental income from the property. In this case, the taxpayer leased property pursuant to an oral lease, the annual term of which was extended several times. Judge Kroupa held that the lease term was indefinite and that the statutory test thus was not met. The § 179 deduction was denied.

7. **Antenna support structures and leased digital equipment have longer lives than the taxpayer would like.** Broz v. Commissioner, 137 T.C. No. 3 (7/7/11). The Tax Court (Judge Kroupa) held that cellular antennas, equipment shelters, and related land improvements were depreciable over 15 years in asset class 48.14 (Telephone Distribution Plant), rather than over seven years in asset class 48.32 (High Frequency Radio And Microwave Systems). The court also agreed with the IRS that cell phone site equipment including base station radio and switching equipment is classified as ten year property under asset class 48.12 (Telephone Central Office Equipment) rather than as five year property under asset class 48.121 (Computer-based Telephone Central Office Switching Equipment). The court concluded that the primary difference between asset classes 48.12 and 48.121 is that the latter category includes equipment that functions as a computer. The digital cellular equipment within the base station functioned as a radio rather than as a computer.

8. **Ouch! Fifteen year recovery period for a one-year lived asset. Covenant not to compete from a minority S corporation shareholder is a § 197 intangible.** Recovery Group, Inc. v. Commissioner, T.C. Memo. 2010-76 (4/15/10). The taxpayer S corporation paid a retiring 23 percent shareholder/employee \$400,000 for a one-year covenant not to compete. The taxpayer asserted that the acquisition of a 23 percent interest was not "entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof" as provided in § 197(d)(1)(E), and claimed a full year's deduction for the amount paid. The court (Judge Gustafson) upon a careful analysis of the statutory phrase concluded that the covenant was part of an acquisition of an interest in a trade or business, that the interest was "substantial," and that in any event the term "thereof" in the statutory language does not modify "an interest," which, therefore, need not be substantial.

a. **And the First Circuit says "Eat your peas" to the taxpayer.** Recovery Group, Inc. v. Commissioner, 108 A.F.T.R.2d 2011-5437 (1st Cir. 7/26/11). In an opinion by Judge Torruella, the Court of Appeals for the First Circuit affirmed the Tax Court decision holding that a covenant not to compete entered into in connection with the redemption of a portion of the stock of a corporation that is engaged in a trade or business is considered a § 197 intangible as defined in § 197(d)(1)(E), regardless of whether the portion of stock acquired constitutes at least a "substantial portion" of such corporation's total stock. The court expressly

rejected the taxpayer's argument that "the term section '197 intangible' means ... any covenant not to compete ... entered into in connection with an acquisition ... of [(1)] [the entire] interest in a trade or business or [(2)] [a] substantial portion [of an interest in a trade or business]," based on the legislative history of the statutory provision. The court reasoned that the purpose of § 197 was to reduce controversies regarding the allocation of purchase price between goodwill and covenant not to compete, and that since goodwill reasonably could be conveyed only if a substantial portion of the assets of a business were transferred, in the context of asset acquisitions, "Congress made [§ 197(d)(1)(E)] applicable only where the covenant not to compete was entered into in connection with the acquisition of at least a substantial portion of assets constituting a trade or business." The court then explained how entering into a covenant not to compete in connection with a stock sale and purchase differed

In the context of stock acquisitions, however, the uncertainty — and consequently the possibility for much litigation between taxpayers and the IRS — caused by the inherent difficulty in valuing goodwill and going concern is generally present even where the purchased stock does not constitute a substantial portion of the corporation's total stock. This is due to the fact that goodwill and going concern generally constitute an essential component of the value of each share of corporate stock, as each share of stock reflects a proportionate allotment of the value of the corporation's goodwill and going concern. ...

If [§ 197(d)(1)(E)] had not applied to a covenant not to compete entered into in connection with the acquisition of a corporation's stock, a buyer of such stock would have had a very significant incentive to allocate to the cost of the covenant what was in fact stock purchase price, because the ostensible cost of the covenant would presumably be amortized and deducted over its usually short useful life, while amounts allocated to the stock's purchase price would not be deductible and would simply form part of the buyer's basis in the stock, presumably to be recovered only after the buyer subsequently disposed of such stock and a capital gain/loss was computed on such disposition.

• According to the court, this analysis explains why "Congress chose different tax treatments for (1) covenants executed in connection with the acquisition of at least a substantial portion of assets constituting a trade or business, as opposed to (2) covenants executed in connection with the acquisition of less than a substantial portion of assets constituting a trade or business."

## F. Credits

1. **Who says Congress doesn't love small businesses? Big businesses are required to buy health insurance for their employees and must pay excise taxes if they don't; small businesses, which aren't required to buy health insurance for their employees, get a tax credit if they do.** New § 45R, added by the 2010 Health Care Act, adds to the § 38 general business credit a credit for health insurance expenses of small business employers, effective for taxable years beginning in 2010. This provision is generally intended to encourage small employers, who are not required to provide health insurance to their employees under other provisions of the Act, to provide health insurance benefits to their employees. Some amount of the credit is available to a business employer with no more than 25 full-time equivalent employees (2,080 hours is an FTE), if the employees have average annual full-time equivalent wages of no more than \$50,000 (as adjusted for inflation after 2014). The full amount of the credit is available only to an employer with 10 or fewer full-time equivalent employees, whose employees have average annual full-time equivalent wages from the employer of less than \$25,000 (as adjusted for inflation after 2014). Seasonal workers are not taken into account. Employer aggregation rules apply. Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S Corporation, and five percent owners of the employer (as defined in § 416(i)(1)(B)(i)) are not treated as employees, and sole proprietors cannot claim the credit with respect to employees who are family members. The credit applies only to contributions under a plan that requires the employer to make a nonelective contribution on behalf of each employee who enrolls in certain defined qualifying health insurance offered to

employees by the employer equal to a uniform percentage (not less than 50 percent) of the premium cost of the qualifying health plan. Before the phase-out rules are applied, the amount of the credit equals the “applicable percentage” of the employer’s mandatory health insurance premium for each covered employee; amounts paid under a cafeteria plan are not taken into account. For 2010 through 2013, the applicable percentage is 35 percent; for years after 2013, the applicable percentage is 50 percent. However, the credit cannot exceed the applicable percentage multiplied by the contributions that the employer would have made during the taxable year if each employee had enrolled in coverage with a “small business benchmark premium” (as defined in the statute). The phase out formula depends on (1) whether the employer has more than 10 employees, (2) whether the employees’ average wages exceed \$25,000, (3) whether both (1) and (2) apply, and whether the year is claimed, i.e., the year after the taxable year with respect to which the credit is claimed, is 2011 through 2013 or after 2013. We will not provide the gory details. The credit is nonrefundable, but may offset AMT liability. The employer’s § 162 deduction is reduced by the amount of the credit.

**a. Healthy credits.** Rev. Rul. 2010-13, 2010-21 I.R.B. 691 (5/3/10). Section 45R enacted in the Health Care Act, provides a credit to eligible small employers (fewer than 25 employees with average annual wages around \$50,000), including tax exempt employers, who make nonelective contributions (contributions that are not part of a salary reduction agreement) towards employee health care based on a percentage of the lesser of (1) the amount of nonelective contributions paid by the small employer and (2) the amount of nonelective contributions the employer would have paid if employees were enrolled in a plan that required the average premium for the small group market in the state in which the employer is offering health care coverage. The ruling sets forth the average premiums for the small group market in each state for the 2010 taxable year. The tables include average premiums for both single coverage and family coverage.

**b. The IRS tells employers how to count, and throws in some transition relief.** Notice 2010-44, 2010-22 I.R.B. 717 (5/17/10), amplified by Notice 2010-82, 2010-51 I.R.B. 857 (12/4/10). These notices provides comprehensive (?) guidance regarding the § 45R credit for small employers that make nonelective contributions towards their employees’ health insurance premiums, including guidance for determining eligibility for the credit, calculating the credit, and claiming the credit. It explains how to determine the number of hours of service worked by employees during the taxable year and how to compute FTEs. The credit is available for add-on dental and vision coverage as well as for traditional health insurance. Because the § 45R credit applies to taxable years beginning in 2010, including the period in 2010 before its enactment, the notice provides transitional relief under which an employer will be deemed to satisfy the requirement that the employer pay a uniform percentage, not less than 50 percent, of the premium cost of the health insurance coverage. For taxable years beginning in 2010, this uniformity requirement will be deemed to have been met if the employer pays an amount equal to at least 50 percent of the premium for single (employee-only) coverage for each employee enrolled in coverage offered to employees by the employer, even if the employer does not pay the same percentage of the premium for each such employee.

**c. More guidance.** Notice 2010-82, 2010-51 I.R.B. 857 (12/4/10). This notice amplifies Notice 2010-44, 2010-22 I.R.B. 717, to provide additional guidance regarding the § 45R credit for small employers that make nonelective contributions towards their employees’ health insurance premiums under a qualifying arrangement. Among the issues addressed are (1) tax-exempt organizations that are not both described in § 501(c) and exempt from tax under § 501(a) are not eligible to claim the credit; (2) a household employer that otherwise satisfies the statutory requirements is eligible to claim the credit; (3) spouses of owners who are treated as employees even if employed by the business; (4) the treatment of leased employees; (5) determination of average annual wages, number of hours worked, and number of FTEs; (6) HSAs and self-insured plans, including HRAs and FSAs, are not qualifying arrangements; (7) calculation of the credit, including the application of the average premium cap.

**2. Once enacted, credits never die.** The Compromise Tax Relief Act of 2010, extends a number of expiring and expired credits.

- The research credit of Code § 41 was retroactively extended to apply to amounts paid or accrued before 1/1/12. Act § 731.

- The 20% credit under Code § 45A for qualified wages and health benefits paid to enrolled Indian tribe members was retroactively extended to amounts paid or incurred in tax years beginning before 1/1/12. Act § 732.

- The 5% credit under § 45D for investment in stock of a community development entity is retroactively extended through 2011. Act § 733.

- The 20% credit provided by § 45P for differential wages paid to employees called to active duty in the armed services is extended through 2011. Act § 736.

- The Work Opportunity Credit of § 51 was extended to individuals who begin work before 1/1/12. The date was extended from 8/31/11. Act § 757.

a. **But the paper manufacturers take a hit.** The Compromise Tax Relief Act of 2010 retroactively eliminates the § Code § 6426(d) alternative fuels credit eligibility for “black liquor” produced by paper milling processes for fuel sold or used after 12/31/09. Act § 704.

3. **Simplified research credit elections regulations are final.** T.D. 9528, Alternative Simplified Credit under Section 41(c)(5), 76 F.R. 33994 (6/10/11). Section 41(c)(5) provides a “simplified” research credit of 14 percent of so much of qualified research expenditure as exceeds 50 percent of the average qualified research expenditures for the three preceding taxable year, or, if the taxpayer has no qualified research expenditures in prior years, the simplified credit is 6 percent of qualified research expenditures for the year. (The regular credit under § 41(a)(1) is 20 percent of qualified expenditures over a base.) Temporary regulations are finalized as Reg. § 1.41-9 to require an election for the alternative simplified credit to be made with the return filed for the year to which the election applies. The election may not be made on an amended return, nor will the IRS grant an extension of time to file the election. While the election may not be revoked absent the consent of the IRS, consent is deemed to have been requested and granted if the taxpayer files a Form 6765 calculating the credit under regular methods and attaches the revocation to a timely filed (including extensions) original return for the year to which the revocation applies. The final regulations allow taxpayers to prorate short tax years by the number of days in the year.

a. **Can the incomprehensively complicated be “simplified”?** T.D. 9539, Election of Reduced Research Credit Under Section 280C(c)(3), 76 F.R. 44800 (8/27/11). These regulations, Reg. § 1.280C-4, “simplify” how taxpayers make the election to claim the “reduced research credit” under § 280C(c)(3).

4. **New markets credit is revised to help markets other than real estate.** REG-101826-11, New Markets Tax Credit Non-Real Estate Investments, 76 F.R. 32882 (6/7/11). Section 45D allows a new markets tax credit for an equity investment at original issue in a community development entity (CDE), an entity that invests in qualified low income community projects. In order to encourage investments in projects other than real estate development proposed regulations would reduce the requirement that returns on investments by a CDE be re-invested in community development projects during a seven year credit period. The proposed regulation would allow a CDE to reinvest capital from non-real estate businesses in unrelated certified community development financial institutions that are CDEs under § 45D(c)(2)(B) at various points during the seven-year credit period. The proposed regulations would allow an increasingly aggregate amount to be invested in certified community development financial institutions in the latter part of the seven year period.

#### G. Natural Resources Deductions & Credits

1. The Compromise Tax Relief Act of 2010, § 706, suspends the Code § 613A limitation on percentage depletion for oil and gas from marginal wells for two years (to apply to tax years beginning before 1/1/12).

a. Under the Compromise Tax Relief Act of 2010, §§ 701-711, energy credits were reinstated and extended two years, including the biodiesel fuels credit, biodiesel mixtures excise tax credit, refined coal credit, alternative fuel tax credit, alternative fuel

mixtures excise tax credit, alcohol fuels credit, ethanol blenders credit, alcohol fuels excise tax credit, energy efficient appliances credit, and the alternative fuel vehicle refueling property credit.

2. **Actually passing gas is required for the alternative fuels credit.** Collins v. Commissioner, T.C. Memo. 2011-37 (2/9/11). On the recommendation of his return preparer, Mr. Tax of America, the taxpayer invested in Gas Recovery Partners to claim a credit under § 29 (now § 45K) for alternative fuel produced from landfills in Puerto Rico and Ohio. The court (Judge Paris) denied the credit because neither petitioners nor the person they dealt with or the partnership they paid had an interest in a fuel-producing source and no fuel was produced. Accordingly, the court found it unnecessary to explore the complexities of the credit provision. The court also denied the taxpayer's claimed expense deductions under §§ 162 and 212 finding that the taxpayer had not engaged in the activity primarily for profit. The court denied a § 165 theft loss deduction for payments made to the partnership finding that there was no evidence that the taxpayer discovered the losses during the years at issue.

#### H. Loss Transactions, Bad Debts, and NOLs

1. **AMT NOLs are different.** Metro One Telecommunications Inc. v. Commissioner, 135 T.C. 573 (12/14/10). In computing AMTI, § 56(a)(4), allows a corporation to claim an AMT NOL in lieu of a regular NOL deduction allowed under § 72. The taxpayer claimed an AMT NOL deduction for 2002 based on a carryback of an AMT NOL from 2004. Analyzing a very complicated statutory pattern, Judge Paris held that § 56(a)(1) does not allow for an AMT NOL carryover to a prior year.

2. **He lost at the track, but showed in the Tax Court.** Mayo v. Commissioner, 136 T.C. 81 (1/25/11). In a reviewed opinion, the Tax Court (Judge Gale) applied § 165(d) to limit the allowable gambling losses of a taxpayer who the IRS conceded was in the "trade or business of gambling on horse races." The court rejected the taxpayer's argument that under the reasoning of the Supreme Court in Commissioner v. Groetzinger, 480 U.S. 23 (1987), which held that § 162 expenses of a professional gambler were deductible in computing AGI (rather than as itemized deductions), the § 165(d) limitation on the deduction of wagering losses to wagering income should not apply to a professional gambler. In this respect, the court reaffirmed its holding in Offutt v. Commissioner, 16 T.C. 1214 (1951), which reached the same result under the 1939 Code predecessor to § 165(d). The taxpayer's \$11,297 net wagering loss was disallowed. However, with respect to the taxpayer's trade or business expenses, the court overruled its opinion in Offutt, which had treated such expenses as additional disallowed losses, and held that the taxpayer's trade or business incurred in connection with his gambling activities (which did not include the amounts actually wagered). Accordingly, the taxpayer was allowed to deduct under § 162(a) the \$10,968 of business expenses incurred in carrying on his gambling business.

3. **Character of income versus character of deductions for venture capital fund managers: Capital gain income and ordinary deductions, or "Heads the taxpayer wins, tails the government loses."** Dagres v. Commissioner, 136 T.C. No. 12 (3/28/11). The Tax Court (Judge Gustafson) held that a \$5 million loan from a venture capital fund manager to a business associate who provided leads on companies in which the venture capital funds (organized as limited partnerships) might invest was proximately related to the taxpayer's trade or business of managing venture capital funds (which was conducted as the managing member of LLCs that were the general partners of the funds, with actual management conducted through an S Corporation owned by the partners (LLC members) of the general partner). Although the venture capital funds' sole activity was investing, the taxpayer's activities in managing the funds on behalf of the investors (even though he had a hefty carry — raking-in over \$40 million for the year in issue), rose to the level of a trade or business. Judge Gustafson reasoned that "[t]he General Partner L.L.C.s were thus different from an investor (whose nonbusiness activity involves buying and selling securities for his own account) and were more like a broker (whose business is to buy and sell securities as inventory for commissions)." He rejected the IRS's argument that the fact that the general partner managing LLCs were one

percent partners rendered their activity investment rather than a trade or business. Significantly, the court observed as follows:

It may be anomalous that, with the IRS's concurrence, a venture capitalist may treat its receipt of "carry" as a nontaxable event, see Rev. Proc. 93-27, sec. 4.01, 1993-2 C.B. 343, 344, and may then report its eventual income as capital gain, see Rev. Proc. 2001-43, sec. 4.01, 2001-2 C.B. 191, 192; 23 but that treatment is not challenged here. Accordingly, even though this profit interest is compensation for personal services, it is deemed to remain passthrough income with the same character in the hands of the recipient (the General Partner L.L.C.) as in the hands of the partnership (the Venture Fund L.P.) — i.e., primarily capital gains from investment. See secs. 701, 702; 26 C.F.R. secs. 1.701-1, 1.702-1, Income Tax Regs. We do not agree with the IRS that the character of this income proves that the General Partner L.L.C.s were investors and were not in a trade or business...

- Because the managing LLCs were in the trade or business of managing investments, that trade or business was imputed to the taxpayer in his capacity as a member manager of the LLCs. See Rev. Rul. 98-15, 1998-1 C.B. 718. Because the taxpayer's income from his management activities was more than twenty times his return from the capital investment, he satisfied the test set forth in *United States v. Generes*, 405 U.S. 93 (1972). Thus, the taxpayer was allowed a business bad debt deduction under § 166(a) for the amount of the loan (\$3,635,218) that was unpaid and uncollectible.

- The court failed to consider the potential application of § 1271, which would have resulted in the taxpayer's loss being a capital loss. Section 1271(a), which has applied to debts issued by individuals since 1997, in relevant part provides as follows: "Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor." Because the debt was retired at less than its principal amount, rather than being wholly worthless, as long as the debt owed to Dages was a capital asset, which it should have been, § 1271 would mandate capital loss treatment. *McClain v. Commissioner*, 311 U.S. 527 (1941), held where a creditor received less than all of the principal of a debt obligation upon the retirement of the debt by the obligor, the predecessor of § 1271 applied to provide capital loss treatment, rather than a bad debt deduction being allowed under the predecessor of § 166, even though if the creditor had received nothing, he would have had a bad debt deduction. Interestingly, however, *McClain* has not been cited in any cases or revenue rulings in over thirty years. (The *McClain* principle has not been applied to taxpayers engaged in the trade or business of making loans by virtue of § 1221(a)(4), see *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *acq. sub. nom.* *United Associates Inc.*, 1965-1 C.B. 5, *modified on other grounds*, 335 F.2d 125 (9th Cir. 1964), but that is another story.)

- In addition, the *Dages* opinion does not discuss Rev. Rul. 2008-39, 2008-2 C.B. 252, which in determining whether investment advisory expenses incurred with respect to an investor upper tier partnership that invested in lower tier partnerships that were traders were deductible under § 212 or under § 162, applied an "on behalf of standard," to determine that the upper tier management fees were § 212 expenses, because they were not incurred "on behalf of" the lower tier partnership, for which management fees were § 162 expenses.

4. **A bad investment in an abusive shelter is a theft loss, but the taxpayer has to prove no possibility of recovery.** *Vincentini v. Commissioner*, T.C. Memo 2008-271 (12/8/08), *aff'd*, 108 A.F.T.R.2d 2011-5060 (6th Cir. 7/12/11) The taxpayer in 1999 invested in an international tax fraud scheme on the basis of listening to audio tapes produced by Keith Anderson, founder of Anderson Ark and attending an Anderson Ark conference in Costa Rica. In a petition challenging the IRS assessment of a deficiency for 1999 denying losses claimed from the taxpayer's Anderson Ark investment, the taxpayer claimed a theft and casualty loss from the investments in 2001 or 2002 that could be carried back to taxpayer's 1999 taxable year. In 2002 the Anderson Ark promoters were convicted of money laundering and/or conspiracy to commit money laundering by the District Court for the Eastern District of California (*United States v. Anderson*, 391 F.3d 970, 974 (9th Cir. 2004)). In 2004 the same defendants were convicted in the Washington District Court on charges of conspiracy to commit wire and mail fraud and to

defraud the United States. The judgment of the Washington District Court ordered the Anderson Ark defendants to provide restitution to Anderson Ark investors, including the taxpayer. The Tax Court (Judge Marvel) held that since the Government in the Anderson Ark criminal cases took the position that the taxpayer was a victim of fraud and was entitled to restitution, judicial estoppel prevented the Government from asserting in the Tax Court that the taxpayer did not suffer a theft loss. However, the court also held that the taxpayer failed to establish that it was reasonably certain at the end of 2001 that the taxpayer would not recover his loss from Anderson Ark. Thus, the casualty loss deduction was denied. In addition, the taxpayer was assessed penalties under § 6662 with respect to losses claimed from the Anderson Ark investment. The court rejected the taxpayer's assertion of reasonable reliance on the advice of a tax professional noting that, reliance on the advice of an accountant who was referred to the taxpayer by the promoter was not reasonable reliance.

a. **Affirmed on appeal.** Vincentini v. Commissioner, 108 A.F.T.R.2d 2011-5060 (6th Cir. 7/12/11) (unpublished). The Court of Appeals found that in examining the evidence the Tax Court could properly conclude that Vincentini did not meet his burden of proving that at the end of 2002 there was no possibility of recovery. The court was not persuaded by Vincentini's assertion that the Tax Court overlooked the facts that in 2002 the Anderson Ark defendants were convicted in California and facing lengthy imprisonment, and that they were represented by appointed council, as providing proof that there was no reasonable possibility of recovery. The court also affirmed the § 6662 penalties noting that Vincentini put his faith in a "biased professional, affiliated with the organization promoting the investments" and that he "either errantly omitted important investigatory steps or chose to ignore the telltale signs of an investment that was too good to be true."

5. **A NOL not used is a NOL absorbed.** Hall v. United States, 108 A.F.T.R.2d 2011-5146 (Fed. Cl. 8/9/11). Section 172(b) provides that net operating losses *shall* be carried back to each of the two taxable years preceding the taxable year of the loss, then forward to each of the next 20 taxable years following the year of the loss. For taxable years beginning before 8/6/97, the carryover was back three years and forward 15 years. Section 172(b)(2) mandates that the entire amount of the loss be carried back to the appropriate years. Section 172(b)(3) allows an election to waive the carryback in a timely filed return for the year in which a loss was incurred. In a refund action based on amended returns, the taxpayer attempted to offset 2003 income with losses going back to 1988. In granting summary judgment to the government, the court stressed that the carryback provision is mandatory unless waived in a timely filed return. Thus, portions of the taxpayer's NOLs were consumed in prior carryback years when the taxpayer had operating income. The court also rejected the taxpayer's argument that the mandatory provisions of § 172 were discriminatory against a group of smaller and less wealthy entities and individuals.

#### **I. At-Risk and Passive Activity Losses**

1. **Homer Simpson loses in the Tax Court. Time off from the nuclear power plant is not being a real estate professional.** Moss v. Commissioner, 135 T.C. 365 (9/20/10). The taxpayer, who worked full time as a maintenance planner at a nuclear power plant, owned several rental real estate properties. The taxpayer recorded the days, but not the time worked in maintenance on the rental properties in a daily calendar. The taxpayer claimed that he worked a total of 645 hours on rental properties (including travel time) and attempted to add time that he was "on-call" anytime he was not working at the power plant in order to satisfy the minimum 750 hour requirement of § 469(c)(7)(B)(ii) to qualify as a real estate professional. The court (Judge Wells) held that only time for services actually performed could be counted towards the 750 hour requirement, which did not include time while the taxpayer was on call. However, the court also found that the taxpayer actively participated in the rental real estate activities and was, therefore, entitled to the § 469(i) \$25,000 allowance, but subject to being phased out to the extent the taxpayer's income exceeded \$100,000. The court also held that the taxpayer was subject to the § 6662 accuracy related penalty.

2. **Now here's really bad grouping.** Dunn v. Commissioner, T.C. Memo. 2010-198 (9/13/10). The Tax Court (Judge Thornton) held that the taxpayer's (1) medical practice conducted as an employee, (2) property management business conducted through an S corporation, and (3) airplane leasing conducted through an LLC could not be grouped for purposes of applying § 469, because they did not constitute an "appropriate economic unit" within the meaning of Reg. § 1.469-4(c)(2). The property management business and the airplane leasing activity were found to be passive activities. Accuracy related penalties were imposed because the taxpayer, and not his advisors, made the decision to characterize the activities as passive or active, and the taxpayer acknowledged on brief that he was "highly educated and sophisticated and possesses extensive business experience" and conceded, "the standard of care that must have been exercised by the Petitioner is a high one."

- The taxpayer's tax advisor testified that "The client would tell us whether or not it was passive or nonpassive. ... We would have to ask the client. We would have no way of knowing without. ... If the client told us it was passive, fine. It was passive. If the client tells us-you know, we don't know unless the client tells us."

- Hum! Circular 230 issue?

3. **A real estate professional must materially participate in her real estate rental activities.** Perez v. Commissioner, T.C. Memo. 2010-232 (10/25/10). Section 469(c)(2) provides that rental real estate activities are per se passive activities. However, § 469(c)(7) excludes rental real estate activities of a real estate professional from the per se rule. The taxpayer was a real estate sales person and broker who owned three residential rental properties. The taxpayer stipulated that she did not materially participate in those activities under the rules of Temp. Reg. § 1.469-5T. The court (Judge Haines) rejected the taxpayer's argument that because she was a qualified real estate professional all of her real estate activities are not passive activities. The court pointed out that the taxpayer's argument ignored the plain language of Reg. § 1.469-9(e)(1), which provides that "a rental real estate activity of a qualifying [real estate professional] is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity." The court also indicated that a taxpayer's activity as a real estate loan agent and broker is separate from the taxpayer's activity as an owner of residential real estate properties, and the activities may not be aggregated. Reg. § 1.469-9(e)(3)(i). The court also sustained § 6662 penalties.

4. **After winning cases on the failure of attempted aggregation elections, the IRS makes relief available to real estate professionals who fail to make timely aggregation elections.** Rev. Proc. 2011-34, 2011-24 I.R.B. 875 (5/27/11). Real estate professionals may make elections under Reg/ § 1.469-9(g) to treat all interests in rental real estate as a single rental real estate activity for making the determination as to whether those professionals materially participate in that activity; if there is material participation, losses from that activity are not treated as passive activity losses. This election is normally made by filing a statement with the taxpayer's original income tax return for the taxable year. Under this revenue procedure, relief for late elections is available provided that (i) the taxpayer failed to file the election with an original tax return in the year the election was to take effect as required by Reg. § 1.469-9(g), (ii) the taxpayer has filed all returns for years subsequent to the year for which an election is made consistent with having made a timely election to aggregate properties, (iii) the taxpayer had timely filed each return affected by the election if it had been made (or filed within six months of the due date excluding extensions), and (iv) the taxpayer had reasonable cause for its failure to file under Reg. § 1.469-9(g). Application for relief is to be made in a statement as required by Reg. § 1.469-9(g)(3) attached to an amended return for the most recent tax year. The statement requires a declaration under penalty of perjury by a person with personal knowledge that "the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The application for relief is not treated as a request for a revenue ruling, and thus does not require user fees.

5. **Ill bank president is not a real estate professional.** Harnett v. Commissioner, T.C. Memo. 2011-191 (8/11/11). The taxpayer founded a savings and loan association to provide financing to customers of his real estate development company. In 2003



the taxpayer suffered a heart attack and other health problems. He resigned as CEO of the bank in 2005, but continued to work as a consultant to the bank and served as chairman of the board. After 2003 the taxpayer had stopped renting his real estate properties and had begun trying to sell them. The real estate was managed partly by the taxpayer's son, his wife, and his former bank secretary. The court (Judge Thornton) found that the taxpayer's unsubstantiated testimony did not meet the burden of proof required to establish that the taxpayer had performed more than 750 hours of service during the tax years at issue and thus failed to qualify as a real estate professional for purposes of § 469(c)(7). The taxpayer's real estate losses were, therefore, passive activity losses not deductible against active income sources. The court found that the taxpayer's statement that he spent most of his time on real estate activities and only 10 hours a month at the bank strained credibility since "for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation" and added that the court saw no reason to think that managing the taxpayer's dormant real estate holdings required him to spend anywhere near 750 hours each year.

**6. This taxpayer piloted ships over the bar of the passive activity loss limitations.** Miller v. Commissioner, T.C. Memo. 2011-219 (9/18/11). Taxpayer was a San Francisco Bay Bar Pilot, which means that he piloted commercial ships in and out of San Francisco Bay over the shallow bar that blocks entrance to the Bay as a partner in the San Francisco Bay Bar Pilots Association. In addition taxpayer served as the contractor on the construction of rental real estate which he and his wife also managed. The taxpayer convinced the court (Judge Kroupa) that he spent more time in real estate activities ["in which he materially participate[d]"] than he did in piloting ships, and that he met the 750 hour requirement [by "performing services ... in real property trades or businesses in which [he] materially participate[d]"] under § 469(c)(7) to qualify as a real estate professional entitled to claim real estate losses without limitation to passive activity income under § 469. However, the taxpayer failed to elect under § 469(c)(7)(A) to treat all of his real estate activities as a single activity. The court found that the taxpayer was a material participant in only two of his six real estate properties having participated more than 100 hours in each activity, which was more than any other participant. The taxpayer failed to establish that he met the 100 hour requirement or that his participation was more than other participants in four properties. The court rejected the IRS imposition of § 6662 accuracy related penalties.

**7. Borrowed funds contributed to S corporation cellular company were neither at-risk nor did they create basis for loss deductions.** Broz v. Commissioner, 137 T.C. No. 5 (9/1/11). In a structure typical for the industry, the taxpayer was the shareholder of two S corporations, RFB and Alpine, that held FCC licenses to operate cellular networks in rural areas. RFB held licenses directly and was the original business. Alpine was formed to expand the business and held the licenses through a number of single-owner LLCs. Alpine and the LLCs were formed at the insistence of creditors to isolate the liabilities of the thinly capitalized expansion. RFB owned and operated all of the equipment. Alpine and its LLCs owned only licenses, and RFB allocated some its income to Alpine for use of the licenses. RFB obtained financing to construct cellular equipment and for working capital, and re-lent some of the loan proceeds to Alpine. Alpine and the taxpayer documented the loans from RFB to Alpine as shareholder loans. The taxpayer pledged RFB stock for the loans, but did not guarantee the loans, which were also secured by corporate assets.

- First, for purposes of determining the taxpayer's basis in Alpine, for purposes of applying the § 1366(d) limitation on passed-through losses, the court (Judge Kroupa) held that (1) the taxpayer had not established that he had borrowed money from the bank that he personally re-lent to Alpine because RFB did not advance the funds to Alpine on the taxpayer's behalf, i.e., the loan ran directly from RFB to Alpine; and (2) the taxpayer had not made any "economic outlay." Thus, the loans were not included in the shareholder's basis to support loss deductions.

- Second, for purposes of determining the taxpayer's at-risk amount with respect to Alpine, in what was described as an issue of first impression, the court held that the RFB stock pledged for the loans represented pledged property used in the business not

eligible to be treated as an amount at-risk by virtue of § 465(b)(2)(A). Since Alpine was formed to expand RFB's cellular networks, the pledged RFB stock was related to Alpine's business. Thus, because the shareholder did not guarantee the loans to Alpine, the shareholder was not economically or actually at-risk with respect to his involvement with Alpine.

- Third, the court held that Alpine could not deduct interest, expenses, and depreciation during the years at issue because it was not yet engaged in an active trade or business utilizing the licenses it held. The court rejected the taxpayer's argument that operation of cellular networks by RFB could be attributed to Alpine. Acquisition of licenses and related equipment was not sufficient to establish Alpine as engaged in the active conduct of a trade or business. Alpine failed to attach the required statement to the return for the taxable year to claim § 195 amortization of start-up expenses [which it could not have deducted even if it had attached the form because it had not yet commenced business operations].

- Fourth, in another issue that the court described as one of first impression, the court concluded that deductions under § 197 for amortization of the costs of FCC licenses were not available in years in which the taxpayers was not yet engaged in a trade or business. The court concluded that the language of § 197 that provides the deduction "in connection with the conduct of a trade or business" requires that the intangibles "must be used in connection with a business that is being conducted."

### III. INVESTMENT GAIN AND INCOME

#### A. Gains and Losses

1. **New rules for determining basis in securities.** The Emergency Economic Stabilization Act of 2008 [Division B], Act § 403, amends § 1012 to create new rules for determining the basis of securities acquired after 12/31/10. The FIFO or other conventions for determining the basis of securities when sold must be applied on an account-by-account basis. Thus, with respect to a taxpayer who holds the same stock in more than one account, determining the basis of sold securities from any account will be determined solely with regard to the basis of securities in that account. In addition, § 1012(d) provides for averaging the basis of stock acquired in a dividend reinvestment plan. Stock in a dividend reinvestment plan is treated as held in a separate account for purposes of determining basis.

- a. **No more fooling the IRS about basis.** The Emergency Economic Stabilization Act of 2008 [Division B], § 403, adding § 6045(g), requires brokers to report the customer's basis in a "covered security" and whether gain or loss is long-term or short-term, in addition to the existing requirement that the broker report gross sales proceeds. In general, the customer's basis is to be reported on a first-in first-out method, unless an average basis method is permissible. Covered securities include securities acquired through an account with the broker or transferred to the broker from another account on or after an applicable date. January 1, 2011, is the applicable date for stocks. January 1, 2012, is the applicable date for stocks under the average basis method. January 1, 2013, or such later date as specified by the IRS, is the applicable date for any other security. Under § 6045A, a taxpayer transferring securities to a broker will be required to report information required by regulations necessary to permit the broker to meet its reporting requirements. Section 6045B requires the issuer of any security to report information describing any organizational action that affects the basis of the security.

- b. **And the IRS begins to gear up.** REG-101896-09, Basis Reporting by Securities Brokers and Basis Determination for Stock, 74 F.R. 67010 (12/17/09). These proposed regulations relate to reporting sales of securities by brokers (Prop. Reg. § 1.6045-1) and determining the basis of securities. (Prop. Reg. § 1.1012-1). The proposed regulations reflect changes in the law made by the Energy Improvement and Extension Act of 2008 that require brokers when reporting the sale of securities to the IRS to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long-term or short-term. The proposed regulations under § 1012 alter how taxpayers compute basis when averaging the basis of shares acquired at different prices and expand the ability of taxpayers to compute basis by averaging with respect to RIC shares and shares specifically held in a dividend reinvestment plan. Brokers must furnish information statements to customers by February 15th. The proposed regulations

provide for the implementation of new reporting requirements imposed upon persons that transfer custody of stock and upon issuers of stock regarding organizational actions that affect the basis of the issued stock. It also contains proposed regulations reflecting changes in the law that alter how brokers report short sales of securities.

**c. Transitional relief from reporting requirements.** Notice 2010-67, 2010-43 I.R.B. 529 (10/12/10). This notice provides transitional relief from the information reporting requirements in § 6045A that apply beginning in 2011 to transfers of securities by brokers and other custodians. The notice provides that, solely for transfers of stock in 2011 described in the notice, the IRS will not assert penalties for failure to furnish a transfer statement under § 6045A and that the transferred stock may be treated as a noncovered security upon its subsequent sale or transfer. ("A noncovered security is any security that is not a covered security.") The notice further provides:

To enable brokers to meet the requirements of section 6045(g) for securities transferred between accounts, section 6045A provides that, beginning in 2011, a broker and any other person specified in Treasury Regulations that transfers custody of a covered security to a receiving broker must furnish to the receiving broker a written statement that allows the receiving broker to satisfy the basis reporting requirements of section 6045(g). Except as provided by the [IRS], the statement must be furnished to the receiving broker within fifteen days after the date of the transfer. A covered security remains a covered security if transferred, but only if the receiving broker receives a transfer statement for the transfer.

**d. Final regulations on basis reporting and basis determination.** T.D. 9504, Basis Reporting by Securities Brokers and Basis Determination for Stock, 2010-47 I.R.B. 670 (11/22/10). These regulations adopt, with only minor changes, the regulations proposed in December 2009. They permit the use of the average basis method by regulated investment companies and dividend reinvestment plans. Brokers must use either the specific identification method or the FIFO method for securities sold from any particular account.

- To minimize the possibility of identification foot-faults, the creation of different accounts to hold securities acquired at different times is recommended.
- The final regulations also permit election of the FIFO method if the securities in any account consist predominantly of dogs.

**e. Interim guidance.** Notice 2011-56, 2011-29 I.R.B. 54 (6/22/11). This notice provides interim guidance under § 1012 on issues relating to the basis of stock pending the anticipated publication of superseding regulations. These regulations will provide that a taxpayer may revoke the broker's average cost method for RIC or DRP stock by notifying the broker to change to the cost basis method before the earlier of one year or the first disposition of stock. Different methods may be used on an account-by-account basis.

**2. When does a debt instrument that has in effect become a proprietary interest because the debtor is insolvent remain a debt instrument?** REG-106750-10, Modifications of Debt Instruments, 75 F.R. 31736 (6/4/10). The Treasury Department has proposed amendments to Reg. § 1.1001-3, which deals with when a modification of a debt instrument results in an exchange for purposes of § 1001 (gain or loss realization by creditor) and § 61(a)(12) (realization of COD income by debtor). Under Reg. § 1.1001-3(e)(5), a modification of a debt instrument that results in an instrument or property right that is not debt for tax purposes is a significant modification. An analysis of all of the factors relevant to a debt determination of the modified instrument at the time of an alteration or modification is required. However, Prop. Reg. § 1.1001-3(f)(7) would clarify that any deterioration in the financial condition of the issuer between the date the debt instrument was issued and the date it was altered or modified, insofar as it relates to the issuer's ability to repay the debt instrument, will not be taken into account in determining whether the instrument has been converted to another type of interest unless there is a substitution of a new obligor or the addition or deletion of a co-obligor. Thus, any decrease in the fair market value of a debt instrument (whether or not publicly

traded) is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the issuer, rather than to a modification of the terms of the instrument, but only for purposes of determining the nature of the instrument. According to the preamble, “[c]onsistent with this rule in the proposed regulations, if a debt instrument is significantly modified and the issue price of the modified debt instrument is determined under Reg. § 1.1273-2(b) or (c) (relating to a fair market value issue price for publicly traded debt), then any increased yield on the modified debt instrument attributable to this issue price generally is not taken into account to determine whether the modified debt instrument is debt or some other property right for Federal income tax purposes. However, any portion of the increased yield that is not attributable to deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.”

• The provisions of Prop. Reg. § 1.1001-3(f)(7) will be effective upon finalization, but taxpayers may rely on paragraph (f)(7) of this section for alterations of the terms of a debt instrument occurring before that date. See Prop. Reg. § 1.1001-3(h)(2).

**a. Finalized with only very minor clarifications.** T.D. 9513, Modifications of Debt Instruments, 76 Fed. Reg. 1603 (1/7/11). The proposed amendments to Reg. § 1001-3 have been finalized with only a clarifying change. The final regulations add language to the general rule of Reg. § 1.1001-3(b) that makes it clear that the rules of Reg. § 1.1001-3(f)(7) apply to determine whether the modified instrument received in an exchange will be classified as debt for Federal income tax purposes. According to the preamble, “unless there is a substitution of a new obligor or the addition or deletion of a co-obligor, all relevant factors (for example, creditor rights or subordination) other than any deterioration in the financial condition of the issuer are taken into account in determining whether a modified instrument is properly classified as debt for Federal income tax purposes.”

**3. The Small Business Act helps small business stock.** Gain realized on a sale or exchange of Qualified Small Business stock under § 1202, which is acquired after the date of enactment of the 2010 Small Business Act (9/27/10) and before 1/1/11, is subject to 100 percent exclusion from gross income. The Act also changed the period for exclusion of 75 percent of such gain from 2/17/09 to the date of enactment (previously the 75 percent rate would have applied up to 1/1/11). Gain attributable to Qualified Small Business stock acquired between 9/27/10 and 1/1/11 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer’s basis in a corporation’s stock sold during the taxable year or \$10 million reduced by gain attributable to the corporation stock excluded in prior years. Qualified Small Business Stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of \$50 million.

**a. So you put off investing in that qualified business before 2011, fear not ye procrastinators.** The Compromise Tax Relief Act of 2010, § 760, extends the 100% exclusion for gain on qualified small business stock under Code § 1202 to stock acquired before 1/1/12.

**4. Rate extensions.** The Compromise Tax Relief Act of 2010, § 102, extends the 15% rate under Code § 1(h) on adjusted net capital gain for regular and alternative minimum tax purposes through 2012. For persons in the 25% or lower brackets, the tax rate on adjusted net capital gain remains at zero. Unrecaptured § 1250 gain will be taxed at a 25% rate, and the rate applicable to collectables and § 1202 gain will remain at 28% through 2012.

**5. The return of tax-free basis step-up (or down) at death — with a very interesting twist for George Steinbrenner and others who followed the same tax planning technique.** The Compromise Tax Act, § 301(a), reinstated the § 1014 fair-market-value-at-death basis rule for taxable years after 2010. For estates of decedents dying in 2010, Act § 301(c) provides a special rule that allows the executor to elect between (1) applying the rules enacted in 2001, i.e., no estate tax for 2010 coupled with the § 1022 carryover basis rules, or (2) paying an

estate tax (applying the rates and exemptions provided in Act § 302 for years after 2009) and applying the § 1014 fair-market-value-at-death basis rules.

**a. Here is how to elect to not pay the estate tax for someone who died in 2010. Nice of them to tell a bit less than three months before the form is due.** Notice, 2011-66, 2011-35 I.R.B. \_\_\_\_ (8/5/11). This notice provides guidance regarding the time and manner in which the executor of the estate of a decedent who died in 2010 elects to have the estate tax not apply and to have the carryover basis rules in ' 1022 apply to property transferred as a result of the decedent's death. It also addresses some issues arising in the application of ' 1022. To elect out of the estate tax and into ' 1022 carryover basis, the executor must file a Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, on or before 11/15/11. (If no executor has been appointed, any person in actual or constructive possession of property acquired from the decedent may file a Form 8939 for the property he or she actually or constructively possesses.) Prior filings purporting to make the ' 1022 Election must be replaced with a timely filed Form 8939. The election is irrevocable except as provided in the Notice. The allocation of any basis increase under ' 1022 must be made on the Form 8939. An allocation of the spousal basis increase may be made on an amended Form 8939 filed after 11/15/11 under certain limited conditions. Executors may apply for ' 9100 relief to (1) revoke an election, (2) seek additional time to allocate a basis increase, or (3) seek additional time to file Form 8939. The Notice cautions, however, that: "Taxpayers should be aware, however, that, in this context, the amount of time that has elapsed since the decedent's death may constitute a lack of reasonableness and good faith and/or prejudice to the interests of the government (for example, the use of hindsight to achieve a more favorable tax result and/or the lack of records available to establish what property was or was not owned by the decedent at death), which would prevent the grant of the requested relief."

**b. And here are the rules for figuring out that nasty carryover basis if you opt out of the estate tax. This Rev. Proc. is long enough and complicated enough to have been a set of regulations, but they probably couldn't have gotten regulations out before the due date of the Form on which you tell them the amount of the carryover basis.** Rev. Proc. 2011-41, 2011-35 I.R.B. \_\_\_\_ (8/5/11). This very long and detailed Revenue Procedure – detailed enough to be worthy of regulations if the issue were permanent – provides safe harbor guidance regarding the determination of the basis of property under ' 1022. It is generally incapable of being concisely summarized, except to say that it describes the types of property and types transfers of property to which ' 1022 does and does not apply. It also describes the types of property for which no allocation of an otherwise permitted basis increase is allowed, and the methods for allocating allowable basis increase among permitted property. No basis increase may be allocated in a manner that increases the basis to increases in value occurring after the decedent's death. The decedent's depreciation deductions for ' 1245 property are taken into account by the transferee in computing ' 1245 recapture. The Revenue Procedure reiterates that under ' 1040, the satisfaction of a pecuniary bequest with property having a fair market value in excess of basis results in gain recognition, noting that this rule does not apply to satisfaction of a pecuniary bequest with an item of IRD. The Revenue Procedure is effective 8/29/11.

**6. The key to the philosopher's stone, which transmutes ordinary income into capital gain.** T.D. 9514, Time and Manner for Electing Capital Asset Treatment for Certain Self-Created Musical Works, 76 F.R. 6553 (2/7/11). Final regulations which add Reg. § 1.1221-3, which deal with the election to treat gain or loss from the sale or exchange of taxpayer-created musical compositions or copyrights in musical works as gain or loss from the sale or exchange of a capital asset. It also covers taxpayers whose basis is determined by reference to the basis of such property in the hands of the taxpayer whose personal efforts created the property.

• This levels the playing field between creators of musical works and creators of patented inventions.

**7. What does "traded on an established securities market" mean in the Internet era?** REG-131947-10, Property Traded on an Established Market, 76 F.R. 1101

(1/7/11). Under the OID rules, if a debt instrument is issued for stock or other debt instruments (or other property) that is traded on an established securities (often referred to as “publicly traded”), the issue price of the debt instrument is the fair market value of the stock or other property. Similarly, if a debt instrument issued for property, such as another debt instrument, is traded on an established securities market, the issue price of the debt instrument is the fair market value of the debt instrument. See Reg. § 1.1273-2(c). Among other issues, a debt-for-debt exchange (including a significant modification of existing debt) in the context of a work-out may result in a reduced issue price for the new debt, which generally would produce (1) COD income for the issuer (i.e., debtor), (2) a loss to a holder (i.e., creditor) whose basis is greater than the issue price of the new debt, and (3) OID that must be accounted for by both the issuer and the holder of the new debt. The Treasury has published proposed regulations that are intended to simplify and clarify the determination of when property is traded on an established market. Prop. Reg. § 1.1273-2(f)(1) would identify four ways for property to be traded on an established market: (1) the property is publicly traded on an exchange (as defined), which is relatively unusual for debt instruments other than corporate bonds; (2) a sales price for the property is reasonably available – “it appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments” (“a sale that is reported electronically at any time in the 31-day time period, such as in the Trade Reporting and Compliance Engine (“TRACE”) database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers”); (3) if a firm price quote to buy or sell the property is available; or (4) a price quote (other than a firm quote) that meets certain standards set forth in the regulations, is provided by a dealer, a broker, or a pricing service (an indicative quote). In all four cases, the time for determining whether the property is publicly traded is the 31-day period ending 15 days after the issue date of the debt instrument. The regulations will apply to debt instruments that have an issue date on or after the promulgation of final regulations.

8. This case is a poster child for the argument that § 1221 ought to list what are capital assets rather than listing what are not capital assets.<sup>1</sup> Tempel v. Commissioner, 136 T.C. No. 15 (4/5/11). On December 17, 2004, the taxpayers donated a qualified conservation easement to a qualified organization and qualified for \$260,000 of conservation easement income tax credits, which were transferrable, from the State of Colorado. They incurred \$11,574.74 of expenses in connection with the donation that primarily consisted of various professional fees. Under complex Colorado statutory provisions (which are not fully explained in the opinion) only \$50,000 of the credits was currently refundable to the taxpayers, and then only in a year in which Colorado had a budget surplus; the excess could be carried over for twenty years. However, Colorado law permitted the sale of excess credits to third parties, who could use them to offset their tax liabilities. In December of 2004, the taxpayers sold \$40,500 of their state tax credits to an unrelated third party for net proceeds of \$30,375. Later in December of 2004, they sold an additional \$69,500 of their credits to another unrelated third party for net proceeds of \$52,125. They reported \$77,603 of short-term capital gains from the sale of their State tax credits, reflecting total sales proceeds of \$82,500 and a basis of \$4,897 in those credits. They computed their basis in the State tax credits by allocating the \$11,574.74 of expenses they incurred to make the donation to the portion of the credits they sold (i.e.,  $\$110,000$  of credits sold /  $\$260,000$  of total credits  $\times$   $\$11,574.74 = \$4,897$ ). The IRS took the position that the sales resulted in ordinary income and that the credits had no basis. The Tax Court (Judge Wherry) rejected the IRS argument that the credits were not capital assets, but agreed with the IRS that the credits had a zero basis. Thus the taxpayers recognized an \$82,500 short-term capital gain.

---

<sup>1</sup>See Martin J. McMahon, Jr., *Reinstating a Capital Gains Preference and Tax Expenditure Analysis*, 48 TAX NOTES 1437 (September 10, 1990).

- The IRS relied on the “substitute for ordinary income” doctrine, which excludes a wide variety of property rights from capital asset status. Judge Wherry rejected the IRS’s argument that the credits were analogous to contract rights to receive ordinary income, which under Tax Court precedent, e.g., *Gladden v. Commissioner*, 112 T.C. 218 (1999), *rev’d on a different issue*, 262 F.3d 851 (9th Cir. 2001), are not capital assets. Judge Wherry likewise rejected the application of the more general “substitute for ordinary income” doctrine. The IRS’s position was that the sales proceeds were a substitute for the up-to-\$50,000 tax refund that a Colorado taxpayer could receive in a year the State had a budget surplus. Judge Wherry noted that there had been no opportunity for a refund from the State either during 2004 (the year the taxpayers sold their credits) or in 2006 through 2010, and that there was no evidence and the IRS did not assert that the taxpayers had sold credits they otherwise could have used to receive a refund. Thus, he concluded that the sales proceeds were not a substitute for a tax refund.

- He also rejected the IRS’s argument that a taxpayer who sells a credit, rather than claiming the credit against his own tax liability has the “economic equivalent of ordinary income” because as a result the taxpayer’s itemized deduction for state income taxes is greater than it would have been had the taxpayer retained and used the credits. Ultimately, he reasoned as follows:

It is also apparent that the transferred State tax credits never represented a right to receive income from the state. Instead, they merely represented the right to reduce a taxpayer’s State tax liability. It is without question that a government’s decision to tax one taxpayer at a lower rate than another taxpayer is not income to the taxpayer who pays lower taxes. A lesser tax detriment to a taxpayer is not an accession to wealth and therefore does not give rise to income.

It follows that the taxpayer who is able to claim a deduction or credit has no more income by virtue of having that right than the taxpayer who is unable to make such a claim. Had petitioners used all of their credits to offset their State tax liability, rather than selling them, it appears that respondent would agree there would have been no income to petitioners. Using a tax credit to offset a tax liability is not an accession to wealth.

Petitioners never possessed a right to income from the receipt of the credits. They did not sell a right either to earned income or to earn income. Consequently, the sale proceeds are not a substitute for rights to ordinary income.

- In a Pyrrhic victory for the IRS on the basis issue, Judge Wherry held that taxpayer’s expenses to create the easement were not the purchase price of the State tax credits under § 1012, but if anything, they were deductible under § 212(3) (which was a question not before the court). Furthermore, allocating basis to the credits would be inconsistent with the basis allocation rules in § 170(e)(2) and Reg. § 1.170A-14(b)(3)(iii)), which allocate the donor’s entire basis in the property between the conservation easement and the retained interest according to the ratio that the fair market value of the easement bears to the total pre-easement fair market value of the property.

- Judge Wherry rejected the taxpayers’ claim, raised in a cross motion for summary judgment, that the holding period of the credits was the same as the holding period of the property the easement burdened. The taxpayer had no property rights in the credits until the donation of the easement was complete and the credits had been granted by the state.

- The taxpayer in this case recognized capital gain treatment with respect to an asset that had never appreciated over the time he held it. That is not the type of situation that should receive preferential treatment. In *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960), the Supreme Court said:

This Court has long held that the term “capital asset” is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation and the entire gain in one year.

• The court cited *Gillette Motor Transport, Inc* and quoted part of the above passage, but gave it no real weight.

a. **Just because a case is wrongly decided doesn't mean it's not binding precedent.** *McNeil v. Commissioner*, T.C. Memo 2011-109 (5/23/11). In a case involving facts substantially the same as the facts in *Tempel v. Commissioner*, 136 T.C. No. 15 (4/5/11), the Tax Court (Judge Cohen) followed *Tempel*, and allowed the taxpayer's claimed short-term capital gain treatment for the proceeds from the sale of state tax credits.

9. **Judge Goeke protects the Lays from IRS overreach following the Enron bankruptcy.** *Estate of Lay v. Commissioner*, T.C. Memo. 2011-208 (8/19/11). In the summer of 2001, when Kenneth Lay was asked by the board of directors to re-take the position of CEO of Enron (which he had resigned in February 2001) upon the unexpected resignation of his successor, Jeffrey Skilling, the Enron board's compensation committee decided that the best way to compensate him and ensure his remaining at Enron was for Enron to purchase two single premium annuities owned by Mr. Lay and his wife for their \$10 million cost. The purchase would both provide liquidity to the Lays and provide a retention device to Enron because the annuities could be earned back by the Lays if Mr. Lay remained as CEO for 4.25 years. The Lays provided the original annuity contracts and transfer documents to Enron on 9/21/01, but instead of providing the original documents to the insurance company, as required by the annuity contracts, Enron faxed them. Enron did not include the \$10 million on the original Form W-2 it sent to Mr. Lay, but in 2004, after an employment tax audit, sent Mr. Lay an amended form W-2 for 2001 that included the \$10 million as compensation. Judge Goeke held, "[w]e do not find this after-the-fact event relevant to the case before us."

• The IRS took the position that the Lays did not sell the annuity contracts and that the \$10 million was an employee cash bonus includable in income for the 2001 year. Judge Goeke found that the Lays completed their requirements to transfer the annuities and that the risks and rewards of the annuity contracts were transferred to Enron on 9/21/01.

• The IRS also took the position that the purchase price of the annuities was in excess of the \$4.691 million the Lays would have received from the insurance company if they liquidated but less than the \$11.2 million that compensation consultant Towers Perrin valued the annuities. Judge Goeke held that, based on *Commissioner v. Brown*, 380 U.S. 563 (1965), the purchase price was within a reasonable range and held that a sale had taken place.

• Judge Goeke also held that no compensation income was realized by virtue of the contractual provision under which lay could earn back the annuity contracts if he worked for Enron for 4.25 years. The annuity contracts were not transferred or set aside and insulated from creditor's claims; Lay had no right to them and they were subject to forfeiture. The contracts were not constructively received and would not be so received until Lay had completed 4.25 years of service (or upon an earlier termination that triggered a transfer to him under the terms of the agreement).

10. **Pizza is the eighth deadly sin, and the ninth is stealing the sausage process, even if the damages are taxable.** *Freda v. Commissioner*, T.C. Memo. 2009-191 (8/25/09). The taxpayer was the shareholder of C&F Packing Co., an S corporation that supplied Pizza Hut with pre-cooked sausage prepared with the taxpayer's patented process. C&F also entered into license and royalty agreements to provide its trade secrets to other Pizza Hut suppliers. After discovering that Pizza Hut disclosed the process to an unlicensed supplier (IBP) who also sold pre-cooked sausage to Pizza Hut, C&F recovered damages from Pizza Hut for misappropriation of trade secrets. The Tax Court (Judge Chiechi) held that the damages were received as compensation for lost profits, and thus were taxable as ordinary income. The court applied the principle that "the tax treatment of the amount at issue 'depends upon the nature of the claim and the actual basis of recovery,'" quoting *Sager Glove Co. v. Commissioner*, 36 T.C. 1173, 1180 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962). The court rejected the taxpayer's argument that the damages were for injury to or destruction of the trade secret, a capital asset.

a. **Affirmed.** *Freda v. Commissioner*, 108 A.F.T.R.2d 2011-5985 (7th Cir. 8/26/11). The Court of Appeals (Judge Tinder) first noted that "trade secret misappropriation, aside from signaling that a capital asset may be in some way implicated, does



not tell us very much about the actual nature of C&F's original claim, which can take many forms." It then went on to hold that the Tax Court's finding that "Pizza Hut paid the amount at issue to [the taxpayer] for 'lost profits, lost opportunities, operating losses and expenditures'" which tracks the language of the relief requested in the complaint and "ha[d] some support in the trial testimony," was not clearly erroneous. In the civil suit, the taxpayer-plaintiff "sought profits and other types of monetary recovery that may properly be taxed as ordinary income from the get-go rather than focusing on the damage to or destruction of its capital asset."

The factual allegations incorporated into C&F's misappropriation claim highlight vast reductions to C&F's margins, ... C&F's financial losses, ..., the disproportionate impact Pizza Hut's conduct had on C&F's total sales, ... and C&F's inability to "exploit" its C&F process ... . The shareholders did not offer the tax court evidence which undercut the Commissioner's reasonable conclusion that the damages C&F alleged were the main attraction rather than mere placeholders; their sole attempt to do so was (properly) rejected on hearsay grounds. They likewise failed to make any effort to explain why they voluntarily treated some of the money they received for a virtually identical claim (trade secret misappropriation against IBP) as ordinary income if all such claims necessarily net capital gains [*sic*]. Based on the record before it, the tax court did not err in upholding the Commissioner's presumptively correct determination that the settlement was not "in lieu of" a replacement of capital.

- Finally, the court noted that "the settlement agreement gives no indication that Pizza Hut believed it was compensating C&F for the sale or even the use of its trade secrets. ... Without at least some hallmarks of a sale, C&F's transfer to Pizza Hut of its trade secrets should not be considered one for tax purposes."

- Judge Manion dissented and would have reversed, on the ground that the Tax Court was "wrong because it misread the complaint." Judge Manion read the complaint, which after describing the elements of its trade secret misappropriation claim against Pizza Hut, C&F alleged that "[a]s a result, C&F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses and expenditures," as including the lost opportunity to negotiate a transfer of the secret process to another pizza giant after Pizza Hut cut C&F off. He concluded that the Tax Court improperly over-emphasized the phrase "lost profits." According to Judge Manion's analysis, the nature of the claim that C&F was bringing against Pizza Hut was that Pizza Hut had wrongfully acquired and then disclosed a trade secret to C&F's competitor, IBP, and that this damaged C&F's property interest in the trade secret in the complaint; the phrase "lost profits" was part of a non-exclusive list describing ways C&F had been injured by Pizza Hut's trade secret misappropriation. But this phrase "lost profits" did not negate the fact that C&F's trade secret had been severely damaged and that C&F was also seeking compensation for this damage.

## **B. Interest, Dividends, and Other Current Income**

**1. Shelve the presentations updating the treatment of redemptions – dividends are taxed about the same.** The Compromise Tax Relief Act of 2010, § 101, extends the 15% rate on qualified dividend income, for both regular and alternative minimum tax purposes, through 2012. Taxpayers in the 10% and 15% brackets pay a zero rate on dividend income through 2012.

**a.** Code § 163(d)(4)(B), which allows an election to treat qualified dividends as investment income but removes the dividends from the benefit of lower rates, is also extended by the Compromise Tax Relief Act of 2010, § 102, through the end of 2012.

**b.** The Compromise Tax Relief Act of 2010, § 102, also extends the rule of Code § 1(h)(11)(D)(ii) that loss on the sale or exchange of stock on which the taxpayer received an extraordinary dividend (generally more than 10% of basis, or 5% in the case of preferred stock) is treated as long-term capital loss.

**C. Profit-Seeking Individual Deductions**

1. **The IRS still can't figure out *Knight*.** Notice 2010-32, 2010-16 I.R.B. 594 (4/1/10). This notice provides that pending further guidance, taxpayers are not required to determine the portion of a "bundled fiduciary fee" that is subject to the § 67 two-percent of AGI floor on miscellaneous itemized deductions for any taxable year beginning before 1/1/10. Taxpayers may deduct the full amount of the bundled fiduciary fee; payments by the fiduciary to third parties for expenses subject to the two-percent floor must be treated separately. It modifies and supersedes Notice 2008-116, 2008-11 I.R.B. 593, which provided similar relief for years beginning before 1/1/09.

a. **And we don't have to until final regulations are published.** Notice 2011-37, 2011-20 I.R.B. 785 (4/13/11). This notice extends the interim guidance provided in Notice 2010-32, 2010-16 I.R.B. 594 (4/1/10), to taxable years that begin before the date final regulations under Temp. Reg. § 1.67-4 are published.

b. **Proposed regulations are published.** REG-128224-06, Section 67 Limitations on Estates or Trusts, 76 F.R. 55322 (9/7/11). These proposed regulations would add Reg. § 1.67-4, to define whether some costs incurred by an estate or non-grantor trust would have been "commonly or customarily ... incurred by a hypothetical individual owning the same property ...." Fees for investment advice would be covered by the 2-percent floor but incremental costs of investment advice incurred because the advice is rendered to a trust or estate are not subject to the floor. Bundled fees may be allocated by "[a]ny reasonable method ...."

2. **The taxpayer fought an almost spot-on example in the regulations and, unsurprisingly, lost on summary judgment.** *Ellington v. Commissioner*, T.C. Memo. 2011-193 (8/11/11). The taxpayers borrowed over \$1.5 million from Merrill Lynch to purchase a residence. The loan was secured by the residence and nearly 9,000 shares of Intel stock worth approximately \$650,000. The taxpayer's subsequently refinanced the Merrill Lynch loan with another lender, and the refinanced loan was secured only by the residence. The taxpayers deducted a portion of the interest on the Merrill Lynch loan as investment interest (because of the statutory ceiling on the amount of the home mortgage for which interest is deductible). The taxpayers argued that a portion of the interest accrued on the Merrill Lynch loan was allocable to the Intel stock because the loan was partly secured by the Intel stock. The Tax Court (Judge Kroupa) rejected the argument, applying the tracing rules in Temp. Reg. § 1.163-8T(c)(1) to conclude that the entire loan was attributable to the purchase of the residence. Under the regulations, debt and interest are allocated to expenditures according to the use of the debt proceeds, and Merrill Lynch had disbursed all of the loan proceeds directly to the sellers from whom the taxpayers had purchased the residence. Judge Kroupa cited Reg. § 1.163-8T(c)(1), Example, which provides that a taxpayer who finances the purchase of a personal-use automobile with a loan secured by corporate stock held for investment incurs personal interest expense, not investment interest expense.

**D. Section 121**

**E. Section 1031**

**F. Section 1033**

**G. Section 1035**

1. **Instructions for qualifying for a tax-free annuity swap.** Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (6/28/11). The direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract (regardless of whether the two annuity contracts are issued by the same or different companies) is a tax-free exchange under § 1035 if no amount, other than an amount received as an annuity for a period of ten or more years or during one or more lives, is withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 180 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer). A transfer that is not treated as a tax-free exchange under § 1035 will be examined under general tax principles to determine if it will be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract, or as boot in

an otherwise tax-free exchange. This Revenue Procedure is effective for transfers completed after 10/23/11. Rev. Proc. 2008-24, 2008-1 C.B. 684, which is modified and superseded, controls transfers before 10/24/11.

#### H. Miscellaneous

### IV. COMPENSATION ISSUES

#### A. Fringe Benefits

1. **How about a little consistency in tax-free drug use?** The 2010 Health Care Act added § 106(f), dealing with employer sponsored Health Flexible Spending Arrangements and Health Reimbursement Arrangements, and amended § 223(d)(2), dealing with HSAs (for individuals with high deductible health plans, whether through an employer or individually) and § 220(d)(2), dealing with individual Archer MSAs, to disallow reimbursement under any such plan for the cost of over-the-counter medicines unless the medicine is prescribed by a physician. Thus, reimbursement is allowed only if the medicine or drug is a prescribed drug, without regard to whether such drug is available without a prescription, or is insulin, which is the rule for deductibility of medicine as a medical expense under § 213. The new provisions are effective after 12/31/10.

a. **And the IRS takes steps to make it more difficult to buy beer and cigs using health FSA and HRA debit cards.** Notice 2010-59, 2010-39 I.R.B. 396 (9/3/10). Current debit card systems are not capable of substantiating compliance with § 106(f) with respect to over-the-counter medicines or drugs because the systems are incapable of recognizing and substantiating that the medicines or drugs were prescribed. For expenses incurred on and after January 1, 2011, health FSA and HRA debit cards may not be used to purchase over-the-counter medicines or drugs. Nevertheless to facilitate the significant changes to existing systems necessary to reflect the statutory change, the IRS will not challenge the use of health FSA and HRA debit cards for expenses incurred through January 15, 2011 if the use of the debit cards complies with prior guidance. However, on and after January 16, 2011, over-the-counter medicine or drug purchases at all providers and merchants (whether or not they have an inventory information approval system (IIAS)) must be substantiated before reimbursement may be made. Substantiation is accomplished by submitting the prescription (or a copy of the prescription or other documentation that a prescription has been issued) for the over-the-counter medicine or drug, and other information from an independent third party that satisfies the requirements under Prop. Reg. § 1.125-6(b)(3)(i).

• Sections 106(f), 220(d)(2) and § 223(d)(2)(A) do not apply to items that are not medicines or drugs, including equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits; such items may qualify as medical care if they otherwise meet the definition of medical care in § 213(d)(1).

b. Notice 2010-59, 2010-39 I.R.B. 396 (9/3/10). To reflect the limitations in § 106(f), the IRS has obsoleted Rev. Rul. 2003-102, 2003-2 C.B. 559, which had held that reimbursements by the employer of amounts expended for medicines or drugs available without a prescription are excludable from gross income under § 105(b). Effective after 1/15/11.

c. Notice 2011-5, 2011-3 I.R.B. 314 (12/23/10), *modifying* Notice 2010-59, 2010-39 I.R.B. 396. After 1/15/11, health FSA and HRA debit cards may continue to be used to purchase over-the-counter medicines or drugs if a prescription is presented to the pharmacist and an Rx number is assigned and retained in a manner that meets IRS recordkeeping requirements.

2. **Going green is hard to do.** Notice 2010-94, 2010-52 I.R.B. 927 (12/15/10). The IRS has delayed to 1/1/12 the effective date of Revenue Ruling 2006-57, which provides guidance to employers regarding the use of smartcards, debit or credit cards, or other electronic media to provide qualified transportation fringes under §§ 132(a)(5) and 132(f).

3. **Did the Tax Court really mean to deny a deduction for a taxable fringe benefit?** *DKD Enterprises, Inc. v. Commissioner*, T.C. Memo. 2011-29 (1/31/11). The Tax Court (Judge Chiechi) upheld the IRS's denial of the corporation's deduction of the cost of medical insurance premiums for a policy covering its employee/sole shareholder because the

corporation “failed to carry its burden of establishing that it had in effect during any of the years at issue a sickness, hospitalization, medical expense, or similar benefit plan for employees.” For that same reason, the individual shareholder /employee was not entitled to exclude the amount of the premiums under either § 105 or § 106.

• Notably, the court did not expressly recharacterize the premium payment as a constructive dividend.

**B. Qualified Deferred Compensation Plans**

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

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

**a.** Notice 2008-113, 2008-51 I.R.B. 1305 (12/3/08). This Notice provides procedures to obtain relief from the full application of the income inclusion and additional taxes requirements of § 409A with respect to certain operational failures to comply with the requirements of § 409A. Comments were also requested on whether procedures for the correction of a failure of a plan to comply with the plan document requirements of § 1.409A-1(c) should be adopted.

**b.** Notice 2010-6, 2010-3 I.R.B. 275 (1/5/10). This Notice provides relief and guidance on corrections of failures to comply with plan documentation requirements of § 409A.

**c.** Notice 2010-80, 2010-51 I.R.B. 853 (11/30/10). This notice expands the relief for nonqualified deferred compensation plans covered by § 409A by reason of both failure to comply with operational requirements and failure to comply with plan documentation requirements.

**2. What’s the FMV of a life insurance policy? Schwab v. Commissioner, 136 T.C. No. 6 (2/7/11).** The Tax Court (Judge Holmes) held that “the amount actually distributed” and therefore includable in gross income under §§ 402(b) and 72 where a variable universal life insurance policy was received as a distribution upon termination of a § 419 nonqualified employee-benefit plan was not the “stated value” determined by the insurance company. Rather the amount distributed was the fair market value of the contract, including paid up insurance, but reflecting surrender charges and other limiting conditions imposed on the beneficiary by the insurance contract. Section 6662 penalties did not apply because the understatement of income, i.e., the amount distributed, was less than \$5,000, and taxpayers were not careless, reckless, or in intentional disregard of rules or regulations.

**3. Getting paid in volatile stock that you cannot sell for a while due to lapsing restrictions is a tax unhealthy behavior. Gudmundsson v. United States, 634 F.3d 212 (2d Cir. 2/11/11).** In 1999, the taxpayer received 73,105 unregistered shares of stock in his employer pursuant to an incentive compensation plan. The stock was worth approximately \$1.3 million. The stock was not subject to forfeiture, but the taxpayer’s ability to transfer the stock was subject to three lapse restrictions. First, pursuant to SEC Rule 144, the stock could not be sold on a public exchange until July 1, 2000, although it could be sold privately or pledged. Second, pursuant to contract with the employer, prior to July 1, 2000, the stock could be sold only certain “permitted transferees,” a group which included family members and relatives. Third, the sale of the stock was limited by the employer’s insider trading policy, which required compliance with certain waiting periods and consent procedures prior to trading the stock. By the time the stock was freely marketable on July 1, 2000, its value had fallen dramatically. The Court of Appeals held that the \$1.3 million value of the stock in 1999 was properly includable in that year under § 83, because it was not subject to a substantial risk of forfeiture. None of the

limitations on trading the stock could result in its forfeiture. Because all of the restrictions were lapse restrictions, none were taken into account in valuing the stock.

4. **At least one kind of forfeiture must have “an objectively reasonable chance of success,” even most do not.** Strom v. United States, 641 F.3d 1051 (9th Cir. 4/6/11). Section 83(c)(3) specifically provides that property will be treated as subject to a substantial risk of forfeiture as long as the sale of the property at a profit “could” subject the individual to suit under § 16(b) of the Securities Exchange Act. The Ninth Circuit held that § 83(c)(3) applies to defer inclusion only if the taxpayer shows that a § 16(b) suit premised on a sale of the property “would have had an objectively reasonable chance of success.” After extensive analysis of the treatment of stock options under the Exchange Act, as applied to the facts, the Court of Appeals reversed the District Court’s judgment for the taxpayer and held that § 83(c)(3) did not apply to defer inclusion. However, it remanded the case to the district court for a determination of whether deferral was allowed under Reg. § 1.83-3(k), which provides that “property is subject to substantial risk of forfeiture and is not transferable so long as the property is subject to a restriction on transfer to comply with the ‘Pooling-of-Interests Accounting’ rules set forth in Accounting Series Release Numbered 130 and ... 135.” The record was not fully developed regarding the existence and terms of any such restrictions.

#### **D. Individual Retirement Accounts**

1. The Compromise Tax Relief Act of 2010, § 725, extended the Code § 408 exclusion for tax-free distributions from IRAs for charitable purposes to years 2010 and 2011.

### **V. PERSONAL INCOME AND DEDUCTIONS**

#### **A. Rates**

1. **Tax rates stay low in anticipation of the next nationwide election cycle.** The Compromise Tax Relief Act of 2010, § 101:

- Retains through 2012 the 10%, 15%, 25%, 28%, 33% and 35% tax rates scheduled to expire at the end of 2010. In addition, the size of the 15% bracket for joint returns and surviving spouses will continue to be 200% of the size of the bracket for unmarried individuals (marriage penalty relief) through 2012.

- The tax relief extension also maintains the 25%, 28%, 33%, and 35% rate brackets applicable to estates and trusts through 2012.

- Under the Compromise Tax Relief Act of 2010 the withholding rate on gambling winnings will remain at 25% instead of rising to 28%.

- The minimum withholding rate on supplemental wages under § 3402 will remain at 25%, and 35% for supplemental wages in excess of \$1 million.

- Rates for voluntary withholding of federal payments such as social security under § 3402 remain at 7%, 10%, 15%, or 25%, instead of rising to 7%, 15%, 28%, or 31%.

- The standard deduction for married couples filing a joint return will be twice the standard deduction for single filers through 2012.

- **No Pease.** Elimination of the overall limitation on itemized deductions of Code § 68 (reducing itemized deductions by 3% of the amount over a threshold but allowing at least 80% of itemized deductions) was to sunset at the end of 2010, but was extended through 2012.

- **No PEP.** The phase-out of the personal exemption for taxpayers under Code § 151(d)(3) of 2% for each \$2,500 of adjusted gross income above a threshold amount is eliminated through 2012.

#### **B. Miscellaneous Income**

1. **The IRS will treat innocent ex-cons better than innocent victims of sexual harassment.** ILM 201045023, Tax Treatment of Compensation to Exonerated Prisoners (11/4/10, released 11/12/10). An individual who was wrongfully convicted of a crime and was wrongfully incarcerated for several years may exclude from gross income under § 104(a)(2) the compensation he receives from the state where “[t]he individual suffered physical injuries and physical sickness while incarcerated.” It may have helped the result that one of the individuals

involved, while meeting with IRS officials, suffered a seizure and had to be carried out of the room by paramedics – apparently the result of head injuries sustained while in prison.

- But see LTR 200041022 (7/17/00), which required that a damage award be allocated between (a) damages awarded for the period of sexual harassment without observable injury and (b) damages awarded for the period after an incident of sexual harassment that resulted in physical injury occurred.

- Are your clients as well prepared for meetings with the IRS as was the ex-con client who had a seizure in the middle of the meeting?

**a. No sympathy for veterans here.** Robinson v. Commissioner, T.C. Memo. 2011-59 (3/10/11). The Tax Court (Judge Wells) held that a pension received from the United States to a retired U.S. Postal Service worker, whose retirement was due to delayed effect of injuries received while serving in the military in Vietnam, was not excludable under § 104(a)(4). The cause of the disability was irrelevant when determining eligibility for the pension. Thus the disability payments the taxpayer received were not paid as compensation for personal injuries or sickness incurred in military service, which is a requirement for § 104(a)(4).

**2. It pays really big tax benefits to run your own church and give yourself two parsonage allowances.** Driscoll v. Commissioner, 135 T.C. 557 (12/14/10) (reviewed). The taxpayer (Phillip Driscoll) received a parsonage allowance from Mighty Horn Ministries, Inc., later known as Phil Driscoll Ministries, Inc., as the Ministries, that was applied to the acquisition and maintenance of not only a principal residence but also a second home — a vacation residence. The IRS disallowed a § 107 exclusion for the portion of the parsonage allowance received with respect to the second home — for four years amounts totaled over \$400,000 — on the grounds that § 107(a) refers to “a home” and that the legislative history limited the § 107 exclusion to only one home. The Tax Court majority, in an opinion by Judge Cheichi (in which four judges joined), with four concurrences, rejected the IRS’s argument, stating “[w]e find nothing in section 107, its legislative history, or the regulations under section 107, which, as respondent points out, all use the phrase “a home,” that allows, let alone requires, respondent, or us, to rewrite that phrase in section 107.” The opinion pointed to § 7701(p)(1) [(m)(1) for the years at issue], which refers to the definition in 1 U.S.C. § 1 that provides that in interpreting the United States Code, the singular includes the plural, unless the context indicates otherwise.

- Judge Gustafson, joined by five other judges, dissented, on the grounds that exclusions should be interpreted narrowly, and “[T]he chance that Congress in 1954 thought it was permitting the exclusion of multiple parsonage allowances seems remote.”

**3. A Blackwater mercenary cannot exclude combat zone pay.** Holmes v. Commissioner, T.C. Memo. 2011-26 (1/31/11). The Tax Court (Judge Goeke) held that income received by a private contractor performing military duties in Iraq during the Iraq war was not excludable under § 112. Section 112 applies only to members of the U.S. armed services and not to civilian employees of military contractors.

**4. The IRS uses taxpayer’s net losses at the casino to prove unreported gross income from other sources.** Pan v. Commissioner, T.C. Memo. 2011-40 (2/14/11). Judge Vasquez upheld the IRS’s reconstruction of unreported gross income determined in part based on currency transactions reports filed by Foxwoods gambling casino. The nongambling gross income was determined to be at least equal to the taxpayer’s net cash expenditures (chip purchases minus the sum of chip redemptions and complementary expenses) at the casino.

**C. Hobby Losses and § 280A Home Office and Vacation Homes**

**1. Really going broke helps prove that it wasn’t a hobby after all.** Dennis v. Commissioner, T.C. Memo. 2010-216 (10/5/10). Judge Paris held that a horse breeding activity conducted by the husband, who had no other source of income was conducted for a profit even though, the losses from the horse breeding activity were applied against his wife’s income from her cosmetology business on their joint return. The income from the cosmetology business would not have been enough to pay their living costs along with the expenses of the horse breeding activity, and the income from the wife’s business could not have absorbed the

losses the husband's horse breeding activity incurred while paying their living costs. Thus, the taxpayer's faced economic hardship because the losses were actual, not merely attributable to depreciation deductions, and depleted their available cash and savings.

2. **They did everything right except make money.** Blackwell v. Commissioner, T.C. Memo. 2011-188 (8/8/11). The taxpayer husband worked full time as a senior officer of a number of motorcycle, snowmobile, ATV, and personal watercraft manufacturing companies. The wife taxpayer was involved in the couple's horse breeding and training activity. During the relevant years in which the couple conducted the horse activity, his salary income ranged from approximately \$371,000 to over \$1,200,000. The wife typically spent 15-20 hours a week on the horse activity and the husband typically spent 2 to 5 hours a week on the horse activity. Over the years they acquired and sold over twenty horses. Over a seven year period the activity lost over \$500,000. Judge Swift held that they conducted the horse activity for a profit motive and that § 183 did not apply to limit their deductions. Before starting the activity they took over seven years learning about horse breeding and management before attempting to start the operation. They were not "absentee, aloof, or recreational horse owners." The wife "managed and worked diligently and daily on the horse activity, doing essentially all of the horse maintenance herself." The taxpayers "consulted expert horsemen, hired expert horse trainers to assist in training the horses, advertised, showed the horses, and paid significant stud fees to have their mares bred with stallions which they regarded as having good bloodlines." They made adjustments to their business plan, maintained reasonably good books and records for the activity, and, after seven years of losses, terminated the activity. "The time, effort, and financial resources [the taxpayers] personally put into and invested in their ... horse activity are not indicative of a hobby; rather, they are indicative of a for-profit activity."

#### D. Deductions and Credits for Personal Expenses

1. **The IRS recedes from Tax Court victories on the scope of "home equity indebtedness."** ILM 200940030 (8/7/09). Home mortgage indebtedness in excess of \$1,000,000 may qualify as home equity indebtedness under § 163(h)(3)(C). The position taken in the memo is inconsistent with *Pau v. Commissioner*, T.C. Memo. 1997-43, and *Catalano v. Commissioner*, T.C. Memo. 2000-82, but it is consistent with the instructions in IRS Pub. No. 936, Home Mortgage Interest Deduction.

- Shouldn't this position be stated in a published revenue ruling since Tax Court decisions are the law and instructions in IRS Publications are not the law?

a. **And the position is stated in a published revenue ruling.** Rev. Rul. 2010-25, 2010-44 I.R.B. 571 (10/14/10). Indebtedness that is incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can constitute "home equity indebtedness" (within the meaning of § 163 (h)(3)(C)) to the extent it exceeds \$1 million.

2. **This revenue procedure refers to Chinese drywall, but is too politically correct to call it by name.** Rev. Proc. 2010-36, 2010-42 I.R.B. 439 (9/30/10). This revenue procedure provides guidance regarding the tax treatment of amounts paid to repair damages to personal residence resulting from "corrosive" drywall building materials (sometimes referred to as "certain imported drywall installed in homes between 2001 and 2008). The reported consequences include the presence of "sulphur gas odors" that corrode copper electrical wiring. The procedure does not mention any alternative possibilities for the presence of "sulphur gas odors" in the home.

- This revenue procedure permits the deduction of 100 percent of repair costs for damage to the residence and to household appliances as a casualty loss in the year of repayment provided that the taxpayer does not pursue reimbursement through property insurance, litigation, or otherwise; the loss deduction is 75 percent if the taxpayer makes a claim for reimbursement. Both deductions are limited by the \$100 floor imposed by § 165(h)(1) and to the 10-percent-of-AGI limitation imposed by § 165(h)(2).

- Contrast the so-called "Chinese Wall," now permitted by the ABA Model Rules of Professional Conduct, Rule 1.10; there it is referred to as a "screen."

3. **Tax stimulus for procreation.** The Code § 24 \$1,000 child tax credit (scheduled to drop to \$500 after 2010) is extended through 2012 under the Compromise Tax Relief Act of 2010, §§ 101, 103.

- The credit remains available against both regular and alternative minimum taxable income. The credit is phased out by \$50 for each \$1,000 of modified AGI above \$110,000 for joint returns, \$75,000 for unmarried individuals, and \$55,000 for married filing separately. The credit remains refundable to the greater of 15% of taxable earned income above \$3,000 or, for a taxpayer with three or more qualified children, the excess of social security taxes over the earned income credit for the taxable year.

4. **Earned Income Tax Credits remain simplified, at least Congress so thinks.** The Compromise Tax Relief Act of 2010, § 103, extends through 2012 certain simplification provisions, originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and scheduled to sunset after 2010, in calculating the refundable earned income tax credit of Code § 32.

- The definition of earned income includes only amounts includible in gross income for the taxable year.

- The phase out of the earned income credit is based on adjusted gross income (rather than modified AGI).

- A child, to be a qualified child, must reside with the taxpayer for more than six months, descendants of step children are qualified children, and siblings, or step siblings are eligible children if the taxpayer cared for them.

- A child is the qualifying child of the taxpayer under the rules of § 152(c) with respect to the dependency exemption except for the support requirement and the § 152(e) rules allowing a non-custodial parent to claim the dependency exemption. A qualifying child must have the same principal place of abode as the taxpayer for at least one-half of the year, and be under age 19, age 24 if a student, or permanently disabled.

- The increased phase-out threshold for joint filers, \$5,000 more than the threshold for other filers (plus inflation adjustments), is extended through 2012.

5. **Multiple individual credits are extended through 2012** by the Compromise Tax Relief Act of 2010 through 2012:

a. The Code § 21 dependent care credit remains at 35% of qualified expenses up to \$3,000 for one qualifying dependent and up to \$6,000 for two or more qualifying dependents. The 35% credit phases out by one percentage, going down to 20%, for each \$2,000 of AGI above \$15,000. Act § 101.

b. Expanded adoption credits, but not refundability, are extended. Act § 101.

c. The nonbusiness energy property credit of Code § 25C is extended to property placed in service before 1/1/12, but at pre-2009 rates, 10% of the cost of energy efficient building envelope components plus \$50 for each advanced main air circulating fan, \$150 for each qualified heater, and \$300 for each item of energy efficient building property. The lifetime limit for the credit is \$500, or \$200 for windows. Also standards for furnaces and boilers were returned to pre-2009 higher levels. Act § 710.

d. The \$5,000 credit for a first time home buyer in the District of Columbia, Code § 1400C, is extended to homes purchased before 1/1/12. The credit phases out beginning at \$70,000 of modified AGI for single filers and at \$110,000 of AGI for a joint return. Act § 754.

6. **Sales tax deductions extended to 2010 and 2011.** The Compromise Tax Relief Act of 2010, Act § 722, extends the election under Code § 164 to deduct State and local sales taxes in lieu of State and local income taxes to the years 2010 and 2011.

7. **Singing ♪ “Yankee Doodle Dandy”♪ supports some of the claimed deductions for which no records were available.** *Zilberberg v. Commissioner*, T.C. Memo. 2011-005 (1/5/11). Judge Wherry applied the *Cohan* rule [*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)] with respect to deductible personal expenses. The taxpayer was allowing \$3,000 of a claimed \$5,000 § 217 moving expense deduction, even though he had inadequate records,



because he established that he had moved for employment purposes and that he had incurred some expenses. He was also allowed \$15,500 of a claimed \$36,250 § 165(c)(3) casualty loss deduction with respect to his residence, where his records were destroyed in the hurricane that gave rise to the casualty.

8. **This ruling is expressly for lactating mothers. Next on the IRS list is a medical expense deduction for the cost of vibrating massagers for wives whose husbands' medical plans do not cover Viagra.** Announcement 2011-14, 2011-9 I.R.B. 532 (2/10/11). This announcement held that breast pumps and supplies that assist lactation are medical care under § 213(d) because "they are for the purpose of affecting a structure of the body of the lactating woman." The announcement did not refer at all to the health of the baby.

• One commentator stated that the use of breast pumps "prevent[s] the medical conditions of engorgement and plugged milk ducts." She also stated that items like nursing pads are "now clearly eligible." 2011 TNT 29-2.

a. **Making what was recently held to be a deductible medical expense into a mandatory freebee. A new mandate under Obamacare makes all this stuff mandatory for group plans, as well as miraculously free for the insureds.** T.D. 9541, Medical Loss Ratio Reporting, 76 F.R. 46621 (8/3/11). Temp. Reg. § 54.9815-2713T(a)(1)(iv) requires coverage by all group plans of contraceptive, breast-feeding and many other services for women without co-pays and without deductibles. REG-120391-10, Medical Loss Ratio Reporting, 76 F.R. 46677 (8/3/11), promulgates identical proposed regulations. The effective date is 8/1/12.

9. **Is this a casualty loss in limbo? Alphonso v. Commissioner, 136 T.C. No. 11 (3/16/11).** The taxpayer owned stock in a N.Y. cooperative housing corporation from which she rented an apartment as her personal residence. When a retaining wall on the grounds of the apartment complex collapsed, the corporation levied an assessment for the cost of repairs, and the taxpayer paid \$26,390, with respect to which she claimed a casualty loss deduction of \$23,188 (reflecting computational limitations in § 163(h)). The IRS disallowed the deduction, and the Tax Court (Judge Chiechi) upheld the disallowance. Judge Chiechi reasoned that under the relevant state law and controlling legal instruments, the taxpayer had no property interest in the retaining wall, which was part of the common grounds – nothing in the lease, the corporation charter and by-laws, or any other governing documents indicated that the taxpayer possessed a leasehold interest, an easement, or any other property interest in the common grounds. Finally, Judge Chiechi rejected the taxpayer's argument that § 216, which allows cooperative apartment owners to deduct their shares of the real estate taxes and mortgage interest paid by the cooperative corporation, should be extended by judicial interpretation to casualty losses. Although Judge Chiechi rejected the IRS's argument that the absence of a reference to casualty losses in § 216 conclusively determined that it did not apply to casualty losses, after examining the legislative history she concluded that Congress intended § 216 to apply only to interest and real estate taxes.

10. **A pang of tax pain. Pang v. Commissioner, T.C. Memo. 2011-55 (3/9/11).** The Tax Court (Judge Gustafson) upheld the disallowance by the IRS of the taxpayer's claim of a § 165(c)(3) casualty loss deduction for damages paid to the plaintiff in a wrongful death suit against the taxpayer, citing *Whitey v. Commissioner*, 13 T.C. 897 (1949). To be a casualty loss the taxpayer's own property must be damaged or stolen, which did not occur in this case.

#### E. Divorce Tax Issues

1. **Did the court really understand the regs? Maes v. United States, 106 A.F.T.R.2d 2010-6752 (D. Mont. 10/13/10).** Section 71(c)(2) provides that an amount is considered to be fixed for child support, and thus is not alimony, if the period over which it is payable is determined with reference to an event relating to a child. Temp Reg. § 1.71-1T(c), Q&A-18, provides that a date is presumed to be clearly associated with an event relating to a child only if (1) the date is within six months on either side of child's eighteenth or twenty-first birthday (or the age of majority under local law) or (2) payments are to be reduced on two or

more dates that are within a year either side of the attaining of a certain age, between eighteen and twenty-four, by two or more children. Notwithstanding these provisions, the court held that no part of payments the divorce agreement designated as alimony, but which were reduced from \$109,000 to \$91,000, and then to \$25,000 in the same years that the two children attained age 20, respectively, was characterized as child support. The court found any presumption that the payments were not alimony was overcome by the facts that (1) the divorce decree made separate provision for child support, (2) the decree did not expressly link reduction of alimony to children attaining age 20; and (3) evidence established that the amount of the payments to the taxpayer were grossed up anticipation of taxpayer reporting the full amount as alimony and paying taxes thereon. Under the relevant state law, the payments would have terminated upon the payee's death.

2. **He was on the hook for the mortgage even if she died, so paying the mortgage wasn't alimony.** *Moore v. Commissioner*, T.C. Memo. 2011-200 (8/16/11). Judge Vasquez held that the payment by the husband of the mortgage debt on the marital home pursuant to the divorce instrument was not deductible as alimony. Because neither the divorce instrument nor state law provided that the husband's obligation to pay the debt would be terminated by the wife's death, the condition in § 71(b)(1)(D) had not been met.

#### F. Education

1. **Tax subsidies continue to help higher education increase tuition.** The Compromise Tax Relief Act of 2010, Act §§ 101, 103, extend multiple education tax expenditures through 2012.

- The American Opportunity Tax Credit, Code § 25A, provides a tax credit of 100% of education expenses up to \$2,000, plus 25% of the next \$2,000, for a maximum credit of \$2,500 per year for an eligible student. The credit phases out for taxpayers with a modified AGI of \$80,000 to \$90,000 for single filers and \$160,000 to \$180,000 for joint returns. The alternative HOPE credit for the first two years of higher education provides a 100% credit for the first \$1,200 of education expenses, plus 50% of the next \$1,200 of education expenses, including tuition and related expenses. Both are extended through 2012.

- Excludable scholarships under Code § 117 include amounts paid for services by the National Health Service Corps Scholarship Program and the F. Edward Gebert Armed Forces Health Professions Scholarship and Financial Assistance Program (Armed Forces Scholarship program).

- Employer provided educational assistance is excluded under Code § 127, even if the education is not job related.

- Higher phase-out ranges remain for above the line student loan interest deductions, between \$60,000 and \$75,000 for single filers and \$120,000 to \$150,000 for joint returns.

- Enhanced contributions to Cloverdale Education Savings Accounts remain at \$2,000 per year through 2012 for beneficiaries under age 18 with phase out amounts based on modified AGI between \$95,000 and \$110,000 for single filers and \$190,000 to \$220,000 for joint returns.

2. **K-12 teacher deductions.** The Compromise Tax Relief Act of 2010, § 721, extends the Code § 62 deduction of up to \$250 of "eligible educator expenses" for K-12 teachers to the years 2010 and 2011.

#### G. Alternative Minimum Tax

1. **Once again band-aids are applied to the individual AMT.** The Compromise Tax Relief Act of 2010, § 201(a), adopts perennial patches to the AMT exemption for 2010 and 2011. The exemption amounts under Code § 55(d) for 2010 are for joint returns and surviving spouses \$72,450. The exemption phases out by 25% of AMTI exceeding \$150,000, eliminating the exemption when AMTI is \$439,800. For unmarried individuals the exemption in 2010 is \$47,450 with a phase out of 25% of AMTI in excess \$112,500 eliminating the exemption when AMTI is \$302,300. The exemption amounts for 2011 for joint returns and surviving spouses will be \$74,450 with the 25% phase out beginning when AMTI exceeds \$150,000,

eliminating the exemption when AMTI is \$447,800. For unmarried filers, the exemption will be \$37,225 with the 25% phase-out beginning when AMTI exceeds \$75,000 eliminating the exemption when AMTI is \$223,900.

- The exemption amounts for married individuals filing separately are 50% of the exemption for joint filers.

- The Code § 1(g) Kiddie Tax Exemptions for 2010 is the child's earned income plus \$6,700, and for 2011, earned income plus \$6,800, but not more than the unmarried individual exemption amount.

2. **Individual nonrefundable personal credits offset AMT.** The Compromise Tax Relief Act of 2010, § 202, allows nonrefundable personal credits to offset both regular tax liability and AMT liability. These include the credits listed in Code §§ 21 through 25D.

## VI. CORPORATIONS

### A. Entity and Formation

1. Did the Tax Court hint that *Moline Properties* might trump the economic substance doctrine, or did it merely conclude that a corporation that passes muster under *Moline Properties* has "economic substance?" *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105 (5/19/11). The sole shareholder of the taxpayer corporation, which manufactured travel trailers, established a sibling corporation (Leading Edge) to provide design and management services, to be performed by the taxpayer's shareholder as an employee of Leading Edge (while he also continued to serve as a managerial employee of the taxpayer), for the taxpayer's manufacturing operations. Leading Edge elected to be an S corporation. The taxpayer also transferred its employees to Leading Edge, which then leased the employees to the taxpayer. The shareholder then sold almost all of the stock of Leading Edge to an ESOP, of which he was the sole beneficiary. The taxpayer made substantial payments (millions of dollars) to Leading Edge for management services. When § 409(p) was amended to eliminate the tax benefits of the structure, in June 2004 Leading Edge repurchased its shares from the ESOP. The IRS disallowed the taxpayer's management fee deductions for 2002 through 2004 on the grounds that (1) Leading Edge "should be disregarded for Federal income tax purposes as Leading Edge Design, Inc. lacked both economic substance and economic purpose and was formed for the primary purpose of obtaining tax benefits", and (2) "Transactions entered into between Leading Edge Design, Inc. and Weekend Warrior Trailers, Inc. should be disregarded for Federal Income tax purposes because they lacked economic substance and economic purpose and were entered into for the primary purpose of obtaining tax benefits." At trial the IRS also argued that the sale of the Leading Edge stock to the ESOP had no business purpose. Applying the *Moline Properties* doctrine (*Moline Properties v. Commissioner*, 319 U.S. 436 (1943)), Judge Marvel held for the taxpayer, stating as follows:

Even if a corporation was not formed for a valid business purpose, it nevertheless must be respected for tax purposes if it actually engaged in business activity. See *Moline Props., Inc. v. Commissioner*, 319 U.S. at 438-439; *Bass v. Commissioner*, [50 T.C. 595, 602 (1968)]. The prongs of the test under *Moline Props.* are alternative prongs. See *Moline Props., Inc. v. Commissioner*, supra at 438-439; *Bass v. Commissioner*, supra at 602; see also *Rogers v. Commissioner*, T.C. Memo. 1975-289 ("Moline establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. \*\*\* Business purpose or business activity are alternative requirements."). Accordingly, the issue turns on whether Leading Edge engaged in business activity. Whether a corporation is carrying on sufficient business activity to require its recognition as a separate entity is a question of fact. *Bass v. Commissioner*, supra at 602 (status of a corporation respected when testimony established that "the corporation was managed as a viable concern, and not as simply a lifeless facade.")

- Judge Marvel then concluded that, on the record, Leading Edge was not a "lifeless facade."

## B. Distributions and Redemptions

1. **Fool me once, fool me twice, but you're not gonna fool me three times in a row.** Media Space, Inc. v. Commissioner, 135 T.C. 424 (10/18/10). The taxpayer's corporate charter granted its preferred shareholders the right to compel redemption of their stock on or after 9/30/03 if a majority of the holders of the specific series elected redemption. Because state law could prohibit the redemption if it would impair the corporation's capital or the corporation might otherwise fail to redeem the shares upon proper demand, the charter required it to pay interest, which increased from 4 percent per annum by 0.5 percent at the end of each 6-month period until paid in full, subject to a maximum rate of 9 percent. The corporation was also required to continue paying the dividend on any shares it did not redeem. On 9/30/03, the taxpayer and the preferred shareholders entered into the forbearance agreement, under which the shareholders agreed to forbear from exercising their redemption rights until 9/30/04, and the corporation agreed to pay the shareholders a "forbearance amount" computed under an interest-like formula. The forbearance agreement was extended several times, with the latest one extending into 2010. The taxpayer deducted the forbearance amount payments as interest and the shareholders reported them as interest. The IRS disallowed the deduction on the ground that the payments were not interest because they were not paid on any indebtedness. Judge Goeke upheld the IRS's determination that the payments were not interest, but allowed deductions under § 162 for the payments in all but one year.

- Regarding the reason the payments were not interest, Judge Goeke concluded as follows:

The redemption right itself does not create the obligation to pay a principal sum (the redemption amount); rather the exercising of the redemption right by the shareholders' written election creates the obligation to pay. Without a written election, no obligation for payment existed. No redemption election was made during the years at issue.

- He rejected the taxpayer's argument that the IRS elevated form over substance, reasoning as follows:

Comparing the results of the forbearance agreement and the results that would have occurred had a redemption election been made reveals a glaring difference: petitioner would not be legally bound to redeem the investors' shares as a result of the forbearance agreement. If the investors had made a redemption election, petitioner would have been bound to redeem the shares pro rata as petitioner became financially able to redeem them. Under the redemption election scenario the investors are entitled to redemption, but under the forbearance agreement the investors retain the choice of whether or not to have their shares redeemed.

- He rejected the IRS's arguments that the payments were not deductible under § 162 as ordinary and necessary business expenses, or that if they were ordinary and necessary business expenses, § 162(k) applied to disallow the deduction on the theory that the expenses were incurred in connection with a redemption. The corporation probably could not have redeemed the stock even if the shareholders exercised the redemption right, and the shareholders had a previously agreed upon right to be paid compensation if they made a redemption election and the corporation was unable to redeem; the forbearance agreement was not in form or in substance a reacquisition of stock.

- The IRS's argument that the payments were § 301 distributions was summarily rejected, because the corporation received valuable deferral rights in exchange therefor.

- Finally, the IRS argued that the payments were required to be capitalized under Reg. § 1.263(a)-4(d)(2)(i) because a financial interest was created or modified. Judge Goeke agreed with the IRS that because the payments were made to modify the corporate charter with respect to the rights of the preferred stock, the payments were required to be capitalized under Reg. § 1.263(a)-4(d)(2)(i). However, he also concluded that the exception to capitalization in Reg. § 1.263(a)-4(f)(1) for payments the benefit of which does not extend beyond the earlier of

(1) twelve months, or (2) the end of the following taxable year applied to the initial and first renewal payments, but that an exception to the exception, and thus § 263, applied to the renewal payments under the third extension. Reg. § 1.263(a)-4(f)(5)(i), provides that “the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal.” Because any two deferral periods considered together lasted longer than 12 months, if there was a reasonable expectancy of renewal (extension) of the forbearance agreement, the 12-month rule would not apply. Applying the five-factor test of Reg. § 1.263(a)-4(f)(5)(ii) to determine if there was a reasonable expectation of renewal – (1) renewal history, (2) economics of the transaction, (3) likelihood of renewal by the other party, (4) terms of renewal, and (5) terminations – in light of the corporation’s financial condition, Judge Goeke concluded that there was no reasonable expectation of renewal for the initial agreement and first renewal, but that there was such an expectation at the time of the second renewal agreement and the at the payments made under the second renewal agreement had to be capitalized.

**C. Liquidations**

**D. S Corporations**

1. **The lifetime of built-in gain gets shorter every year.** The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation’s tax year beginning in 2011. Before the change the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010.

2. **Despite wildly disproportionate distributions, with no evidence of corrective distributions, the corporation was still an S corporation.** Miller v. Commissioner, T.C. Memo., 2011-189 (8/9/11). The taxpayer reported that he had gifted 95 percent of the stock of his S corporation, having a basis of \$823,450, to his son in 2002, leaving him with a basis of only \$43,339 in his remaining stock. For 2003 the corporation’s original tax return allocated 5 percent of its \$366,162 of income (\$18,308) to the taxpayer and 95 percent to the son. In 2003 the corporation distributed \$619,551 to the taxpayer and \$385,692 to the taxpayer’s son. After audit, the IRS determined that the taxpayer had received distributions of \$548,664 that exceeded his basis in the stock. The parties stipulated that the corporation was an S corporation, despite the disproportionate distributions. Judge Cohen rejected the taxpayer’s argument that because of the disproportionate distributions, the events should be recharacterized to treat the effective date of the transfer of stock from the taxpayer to his son as occurring after the disproportionate distributions. Accordingly, the deficiency was upheld.

3. **Poison pill warrants issued in an S corporation tax shelter scheme turn truly poisonous to S corporation status.** Santa Clara Valley Housing Group, Inc. v. United States, 108 A.F.T.R.2d 2011-\_\_\_\_ (N.D. Cal. 9/21/11). The stock of Santa Clara Valley Housing Group, Inc. (SCVHG) originally was held by a husband and wife and their children. To implement a KPMG tax shelter product known as the S Corporation Charitable Contribution strategy (SC2), SCVHG recapitalized itself so as to have 100 shares of voting stock and 900 shares of nonvoting stock. SCVHG also issued to each shareholder a warrant to purchase ten shares of nonvoting stock for each share of voting stock (which was tax-free under § 305(a)). The warrants were issued solely to protect the original shareholders’ interest in SCVHG while they engaged in the SC2 strategy. (The warrants protected against the possibility that the donee charity would refuse to sell its stock back to the original shareholders after the agreed-upon length of time, because if the warrants were exercised, the warrants would dilute the stock held by the charity to such an extent that the original shareholders would end up owning approximately ninety percent of the outstanding shares.) Thereafter, the shareholders transferred all of the nonvoting stock to stock to the City of Los Angeles Safety Members Pension Plan (CLASMPP), a tax-exempt entity as a “donation,” with the understanding that CLASMPP would sell the shares back after a certain period of time. While CLASMPP held the stock, SCVHG reported over \$114 million of income, of which more than \$100 million was passed through to

CLASMPP, but CLASMPP received distributions of only \$202,500, representing .02 percent of the income allocated to CLASMPP. After four years, CLASMPP sold the 900 shares of stock back to the original shareholders for \$1,645,002, and the warrants were cancelled. The IRS concluded that the transaction was an abusive tax shelter. The IRS concluded that under Reg. § 1.1361-1(D)(4)(ii) the warrants constituted a second class of stock in SCVHG and SCVHG's status as an S corporation was terminated and issued a deficiency notice based upon treating SCVHG as a C corporation. The District Court agreed with the IRS. The warrants "constitute equity," and were intended to prevent CLASMPP "from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company's shares." Thus the warrants were a second class stock and SCVHG's S corporation status was terminated. However, the warrants were not a second class of stock under Reg. § 1.1361-1(D)(4)(iii), which provides that options are a second class if, under the facts and circumstances, (1) the option is substantially certain to be exercised and (2) has an exercise price substantially below the fair market value of the underlying stock on the date the option is issued. In this case it was never intended that the options be exercised; they were a "poison pill."

#### E. Mergers, Acquisitions and Reorganizations

1. **This case decided under old case law might come out differently if decided under new regulations.** Ralphs Grocery Co. v. Commissioner, T.C. Memo. 2011-25 (1/27/11). This case involved the validity of a joint § 338(h)(10) election with respect to the transfer of the stock of a subsidiary in the course of a chapter 11 bankruptcy proceedings of its parent corporations, in which the stock of the subsidiary was eventually distributed to parent corporation's creditors. The question was whether the transfer was a sale and purchase, as argued by the taxpayer, or a tax-free reorganization, as argued by the IRS. The Tax Court (Judge Chiechi) held that the § 338(h)(10) election was valid, because the acquisition of stock was a purchase as defined in § 338(h)(3) and a qualified stock purchase under § 338(d)(3), and rejecting the IRS's claim that it was a reorganization. The IRS's argument was based on the fact that the consideration received by the transferor corporations was stock of the transferee corporation, and that although the stock received was transferred to creditors, under *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), the creditors were equity holders of the parent corporations for continuity-of-interest purposes. Judge Chiechi found the continuity of interest requirement not to have been satisfied, distinguishing *Alabama Asphaltic*. Judge Chiechi found the *Alabama Asphaltic* and its progeny differed from the instant case because in those cases the creditors had instituted involuntary bankruptcy proceedings or took other "proactive" steps to "take 'effective command'" over the corporation's assets. In this case, however, the chapter 11 proceeding was voluntary, and "none of the ... creditors took any proactive steps to enforce or protect their respective rights to payment ... of their respective debts." Thus, the acquisition of Ralphs' stock was a purchase as defined in § 338(h)(3) and a qualified stock purchase under § 338(d)(3), and consequently the § 338(h)(10) election was valid.

• Note that if this transaction had occurred in a later year in which Reg. § 1.368-1(e)(6) would have controlled (on and after 12/12/08), the determination of whether the continuity of interest requirement for a reorganization was satisfied, and the result might have differed. To treat the creditors as holders of a proprietary interest for continuity of interest purposes, Reg. § 1.368-1(e)(6) does not require that the creditors have instituted involuntary bankruptcy proceedings or took other "proactive" steps to "take 'effective command'" over the corporation's assets. Reg. § 1.368-1(e)(6) simply provides that "[a] claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors will be treated as a proprietary interest ... ." None of us has had the patience to wade through the pages and pages of fact findings in the case to try to figure out what the result actually might have been had the current regulations applied.

2. **The Ninth Circuit finds basis in rights created from the collapse of the savings and loan industry in the 1970s: the hell with § 362(b).** Washington Mutual Inc. v. United States, 636 F.3d 1207 (9th Cir. 3/3/11). The taxpayer, as the successor corporation to Home Savings of America, filed a refund action claiming amortization deductions for certain

rights, and loss deductions for abandonment of branching rights, created in a § 368(a)(1)(G) reorganization by the Federal Savings and Loan Insurance Corporation (FSLIC) in which Home Savings acquired three failed savings and loan associations in a transaction structured. The District Court granted summary judgment to the IRS, concluding that Home Savings had no basis in the rights. The Ninth Circuit reversed and remanded, disagreeing with the District Court's conclusion regarding basis. As part of the acquisition of the three failed thrifts in a supervisory merger transaction structured as a type G reorganization, FSLIC entered into an "Assistance Agreement" with Home Savings that included, among other things, approval for Home Savings to establish branches in Florida and Missouri as if Home Savings maintained its home office in those states, and approval of the purchase method of accounting under which Home Savings was permitted to apply a percentage of acquired intangible assets in its deposit base and for amortization of the remainder over 40 years. The Ninth Circuit accepted the taxpayer's argument and concluded that the excess of liabilities of the acquired thrifts over the value of assets represented a cost that was consideration for the rights represented in the assistance agreement in the integrated transaction, and concluded that allowing the taxpayer a cost basis was not inconsistent with characterizing the transaction as a § 368(a)(1)(G) reorganization, notwithstanding the transferred basis rule of § 362(b). The Court rejected the IRS' assertion that "recognizing Home Savings a cost basis in the Rights based on the assumption of FSLIC's liabilities requires characterizing some of the acquired thrifts' liabilities as FSLIC's liabilities, because Home Savings did not pay FSLIC or the Bank Board separate consideration for the Rights." The District Court concurred with the IRS position holding that the excess liabilities of the acquired thrifts were the same as FSLIC's insurance liabilities which remained liabilities of FSLIC. The Ninth Circuit reasoned that Home Savings received a generous incentive package, the cost of which was the excess of the failing thrifts liabilities over the value of their assets. A concurring opinion argued that the acquired rights had a fair market value basis as acquired directly from FSLIC in exchange for taking over the liabilities of the failed thrifts. The Ninth Circuit remanded the case to the District Court to determine the proper amortization amounts for the intangibles and the amount of abandonment loss for the branch rights.

**3. The IRS tells corporations how to determine transferred basis when they don't know who the transferors were.** Rev. Proc. 2011-35, 2011-25 I.R.B. 890 (6/1/11). The IRS has published revised procedures that update, revise, and replace the survey methodology of Rev. Proc. 81-70, 1981-2 C.B. 729, for corporations to determine the basis of the stock of a target corporation acquired in a tax free reorganization in which the acquirer takes a transferred basis, i.e., in § 368(a)(1)(B) reorganizations and § 368(a)(2)(E) reorganizations that could have qualified as a § 368(a)(1)(B) reorganization (if the acquirer elects a transferred basis). These new procedures in part to reflect the fact that shares are often held by nominees under confidentiality agreements not to disclose true ownership. The revenue procedure provides safe harbors to determine the basis of shares acquired from various categories of transferring shareholders, including reporting shareholders, registered non-reporting shareholders, and nominees. The revenue procedure describes methodologies for determining the basis of acquired shares: the acquiring corporation may follow procedures for surveying all surrendering target shareholders, use a statistical sampling when a full survey is not feasible, or use one of two statistical sampling techniques when specified criteria are met. An acquiring corporation may use a different methodology as agreed between the IRS and the acquiring corporation. However, if the acquiring corporation has actual knowledge of a surrendering shareholder's basis in acquired stock, that basis must be used for the acquired shares.

**4. This District Court decision, if followed, makes it much much more difficult ever to have personal goodwill as an employee-shareholder.** Howard v. United States, 106 A.F.T.R.2d 2010-5533, 2010-2 U.S.T.C. ¶50,542 (E.D. Wash. 7/30/10). The taxpayer was a dentist who practiced through a solely owned (before taking into account community property law) professional corporation until the practice was sold to a third party. He had an employment agreement with the corporation with a noncompetition clause that survived for three years after the termination of his stock ownership. The purchase and sale agreement allocated

\$47,100 to the corporation's assets, \$549,900 for the taxpayer-shareholder's personal goodwill, and \$16,000 in consideration of his covenant not to compete with the purchaser. The corporation did not "dissolve" until the end of the year following the sale. The taxpayer reported \$320,358 as long-term capital gain income resulting from the sale of goodwill (the opinion does not explain how the remainder of the sales price was reported, but the IRS recharacterized the goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the third party as a dividend from the taxpayer's professional service corporation. Because the sale occurred in 2002, when dividends were taxed at higher rate than capital gains, a deficiency resulted. The government's position was based on three main reasons: (1) the goodwill was a corporate asset, because the taxpayer was a corporate employee with a covenant not to compete for three years after he no longer owned any stock; (2) the corporation earned the income, and correspondingly earned the goodwill; and (3) attributing the goodwill to the taxpayer-shareholder did not comport with the economic reality of his relationship with the corporation. After reviewing the principles of *Norwalk v. Commissioner*, T.C. Memo. 1998-279, and *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the court held that because the taxpayer was the corporation's employee with a covenant not to compete with it, any goodwill generated during that time period was the corporation's goodwill. The court also rested its holding that the goodwill was a corporate asset on its conclusions the income associated with the practice was earned by the corporation and the covenant not to compete, which extended for three years after the taxpayer no longer owned stock in the corporation rendered any personal goodwill "likely [of] little value."

• See *Solomon v. Commissioner*, T.C. Memo. 2008-102, for an extended discussion of the issues underlying an attempted sale of individual goodwill.

a. **Affirmed – "Dr. Howard has offered no compelling reason why he should be let out of the corporate structure he chose for his dental practice."** 108 A.F.T.R.2d 2011-5993 (9th Cir. 8/29/11) (nonprecedential opinion). The Ninth Circuit affirmed the district court in an opinion that contains an elegantly concise summary of the current state of the law.

Goodwill "is the sum total of those imponderable qualities which attract the custom of a business, -- what brings patronage to the business." *Grace Brothers v. Comm'r*, 173 F.2d 170, 175-76 (9th Cir. 1949). For purposes of federal income taxation, the goodwill of a professional practice may attach to both the professional as well as the practice. See, e.g., *Schilbach v. Comm'r*, 62 T.C.M. (CCH) 1201 (1991). Where the success of the venture depends entirely upon the personal relationships of the practitioner, the practice does not generally accumulate goodwill. See *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 at 207-08 (1998). The professional may, however, transfer his or her goodwill to the practice by entering into an employment contract or covenant not to compete with the business. See, e.g., *Norwalk v. Comm'r*, 76 T.C.M. (CCH) 208, \*7 (1998) (finding that there is no corporate goodwill where "the business of a corporation is dependent upon its key employees, *unless* they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation") (emphasis added); *Martin Ice Cream Co.*, 110 T.C. at 207-08 (finding that "personal relationships ... are not corporate assets when the employee has *no* employment contract [or covenant not to compete] with the corporation") (emphasis added); *Macdonald v. Comm'r*, 3 T.C. 720, 727 (1944) (finding "no authority which holds that an individual's personal ability is part of the assets of a corporation ... where ... the corporation does *not* have a right by contract or otherwise to the future services of that individual") (emphasis added). In determining whether goodwill has been transferred to a professional practice, we are especially mindful that "each case depends upon particular facts. And in arriving at a particular conclusion ... we ... take into consideration all the circumstances ... [of] the case and draw from them



such legitimate inferences as the occasion warrants.” *Grace Brothers v. Comm’r*, 173 F.2d 170, 176 (9th Cir. 1949).

• Looking at the facts as found by the District Court, the Ninth Circuit concluded that “while the relationships that Dr. Howard developed with his patients may be accurately described as personal, the economic value of those relationships did not belong to him, because he had conveyed control of them to the Howard Corporation.” Furthermore, the court rejected the taxpayer’s argument that the purchase and sale agreement impliedly terminated both the employment contract and the non-competition agreement, thereby transferring the accumulated goodwill of the practice back to Dr. Howard, added that even if it accepted that argument, “such a release would constitute a dividend payment, the value of which would be equivalent to the price paid for the goodwill of the dental practice.”

#### **F. Corporate Divisions**

#### **G. Affiliated Corporations and Consolidated Returns**

1. **We can always use some new consolidated return regs — they’re still too easy to understand.** T.D. 9515, Guidance Under Section 1502; Amendment of Matching Rule for Certain Gains on Member Stock, 76 F.R. 11956 (3/4/11). The Treasury has promulgated final amendments to Reg. § 1.1502-13 that provide for the redetermination of intercompany gain as excluded from gross income in certain transactions involving stock transfers between members of a consolidated group. Under the regulations, intercompany gain with respect to member stock may be permanently excluded from gross income following certain stock basis elimination transactions, for example, tax-free spin-offs and § 332 liquidations. The rule in the regulations applies only if: (1) the group has not and will not derive any Federal income tax benefit from the intercompany transaction; and (2) the excluded gain will not be treated as tax-exempt income for purposes of the investment adjustment regulations. The excluded gain is not treated as tax exempt income for purposes of § 1.1502-32 and does not increase earnings and profits.

• The Treasury also has revised Temp. Reg. § 1.1502-13T (as promulgated in 2009) to take into account the above-described amendments to the final regulations and repromulgated it in the revised form without substantive change. Generally speaking, these regulations provide that an intergroup liquidation- reincorporation that also could be treated (under step-transaction, substance over form, or recast) as a tax-free reorganization (asset transfer for stock followed by liquidation) will be treated as a reorganization

#### **H. Miscellaneous Corporate Issues**

1. **Textron, Schmextron — the IRS is going to just require taxpayers to rat out their uncertain positions on the return itself via Schedule “COME AUDIT ME.” This would even permit the IRS to send a statutory notice without having to perform an audit.** Announcement 2010-9, 2010-7 I.R.B. 408 (1/26/10). The IRS announced that it was developing a new schedule to be filed with Form 1120, which would require corporations with more than \$10 million in assets and one or more uncertain tax positions to disclose those positions. The schedule would require both (a) a concise description of each uncertain position for which the taxpayer has recorded a reserve in its financial statement [defined broadly to include some positions for which the taxpayer has not recorded a reserve because it expects to litigate the position or because the taxpayer has determined that the IRS has a general administrative practice not to examine the position] and (b) the maximum amount of potential federal tax liability attributable to each uncertain position if it were disallowed in its entirety.

• The taxpayer will not be required to disclose the taxpayer’s risk assessment or tax reserve amounts, although in the Announcement the IRS states that under *United States v. Arthur Young*, 465 U.S. 805 (1984), it can compel the production of that information through a summons. To be sufficient, the description must contain:

1. The Code sections potentially implicated by the position;
2. A description of the taxable year or years to which the position relates;
3. A statement that the position involves an item of income, gain, loss, deduction, or credit against tax;

4. A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
5. A statement whether the position involves a determination of the value of any property or right; and
6. A statement whether the position involves a computation of basis.

- A number of the above requirements were eliminated from the final Schedule UTP.

**a. Draft Schedule UTP is released.** Announcement 2010-30, 2010-19 I.R.B. 668 (4/19/10). This announcement released draft Schedule UTP to Form 1120, together with draft instructions. It requires that, beginning with returns filed for years beginning in 2010 and thereafter, the following taxpayers with both uncertain tax positions and assets equal to or exceeding \$10 million will be required to file Schedule UTP if they or a related party issued audited financial statements: (1) Corporations who are required to file a Form 1120, U.S. Corporation Income Tax Return; (2) Insurance companies who are required to file a Form 1120 L, U.S. Life Insurance Company Income Tax Return or Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and (3) Foreign corporations who are required to file Form 1120 F, U.S. Income Tax Return of a Foreign Corporation.

- For 2010 tax years, the IRS will not require a Schedule UTP from Form 1120 series filers other than those identified above (such as real estate investment trusts or regulated investment companies), pass-through entities, or tax-exempt organizations. The IRS stated that it will determine the timing of the requirement to file Schedule UTP for these entities after comments have been received and considered.

- Query whether disclosures on Schedule UTP can serve as substitutes for disclosures made on Forms 8275 and 8275R? Yes, the instructions so provide.

**b. Proposed regulations authorizing Schedule UTP, requiring corporations to rat themselves out.** REG-119046-10, Requirement of a Statement Disclosing Uncertain Tax Positions, 75 F.R. 54802 (9/9/10). The Treasury has published proposed amendments to Reg. § 1.6012-2 to require corporations to attach a Schedule UTP, Uncertain Tax Position Statement (or any successor form) to their income tax returns in accordance with forms, instructions, or other appropriate guidance provided by the IRS. According to the preamble, “[t]he IRS intends to implement the authority provided in this regulation initially by issuing a schedule and explanatory publication that require those corporations that prepare audited financial statements to file a schedule identifying and describing the uncertain tax positions, as described in FIN 48 and other generally accepted accounting standards, that relate to the tax liability reported on the return.” When adopted as a final regulation, this rule will apply to returns filed for tax years beginning after December 15, 2009, and ending after the date of publication of these rules as final regulations.

**c. Read all about it! Schedule UTP will be less onerous than originally proposed.** Announcement 2010-75, 2010-41 I.R.B. 428 (9/24/10). The IRS announced changes to the proposed Form UTP and delayed implementation for all but the largest taxpayers. The major changes include the following: (1) For corporations with total assets under \$100 million, there will be a phase-in of the reporting requirement based on a corporation’s asset size. Corporations that have total assets equal to or exceeding \$100 million must file Schedule UTP starting with 2010 tax years. The threshold will be reduced to \$50 million starting with 2012 tax years and to \$10 million starting with 2014 tax years. (The IRS will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later tax years, such as pass-through entities and tax-exempt entities.). (2) The proposed reporting of a maximum tax adjustment has been eliminated. Instead, a corporation must rank all of the reported tax positions (including valuation positions) based on the federal income tax reserve (including interest and penalties) recorded for the position taken in the return, and must designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the tax positions reported on the schedule. (3) Taxpayer’s will not be required to report of the rationale and nature of uncertainty in the concise description of the position. Instead, the Schedule UTP must provide a concise description of the tax position, including a

description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to inform the IRS of the identity of the tax position and the nature of the issue. (4) The proposed requirement that a corporation report tax positions for which no reserve was recorded because the corporation determined it was the IRS's administrative practice not to raise the issue during an examination has been eliminated.

**d. IRS modifies "policy of restraint" in connection with Schedule UTP preparation.** Announcement 2010-76, 2010-41 I.R.B. 432 (9/24/10). The IRS modified its "policy of restraint," which provides that, with certain exceptions, the IRS will not assert during an examination that privilege has been waived by a disclosure when a document that was otherwise privileged under the attorney-client privilege, the tax advice privilege in § 7525, or the work product doctrine, was provided to an independent auditor as part of an audit of the taxpayer's financial statements. See Announcement 2002-63, 2002-21 CB 72; IRM 4.10.20. Under the revisions, taxpayer may redact certain information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP it is asked to produce during examination: (a) working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP; (b) the amount of any reserve related to a tax position reported on Schedule UTP; and (c) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position. Other than requiring the disclosure of the information on the schedule, the requirement to file Schedule UTP does not affect the policy of restraint.

- Query whether FIN 48 workpapers are available to the IRS either through a summons for the papers used for the preparation of part of a tax return or through disclosure by potential whistleblowers who are being solicited by plaintiffs' law firms.

**e. Final regulations authorizing Schedule UTP.** T.D. 9510, Requirement of a Statement Disclosing Uncertain Tax Positions, 75 F.R. 78160 (12/15/10). The final regulations authorize the requirement of filing Schedule UTP, generally following the proposed regulations. They are silent as to the availability of any provision relating to the disclosure of privileged information.

- The final regulations apply to tax returns filed only for years beginning after 12/31/09.

**2. Miscellaneous and generally obsolete corporate tax rates are extended.** The Compromise Tax Relief Act of 2010, § 102, which extended the 15% rate on dividends also extended through 2012 the 15% rate applicable to the accumulated earnings tax and the undistributed personal holding company income tax. Otherwise the rates would have increased to 39.6%. See Joint Committee Technical Explanation, JCX-55-10 (12/10/10), at 26 fn. 29.

**3. Collapsibles remain collapsed for two more years.** The Compromise Tax Relief Act of 2010, § 102, extends the repeal of the collapsible corporation provisions through 2012. The collapsible corporation rules were originally repealed in 2002 but the repeal was scheduled to expire at the end of 2010. See Joint Committee Technical Explanation, JCX-55-10 (12/10/10), at 26 fn. 29.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

**1. Creation of two wholly owned corporations as LLC members didn't avoid disregarded entity status.** Robucci v. Commissioner, T.C. Memo. 2011-19 (1/24/11). The taxpayer converted his psychiatric practice from a sole proprietorship into an LLC. The members of the LLC consisted of the taxpayer and two corporations, both of which were wholly owned by the taxpayer. The taxpayer owned 95 percent of the LLC interests, 85 percent as a limited partner based on the value of transferred intangibles and 10 percent as a general partner based on the taxpayer's provision of medical services. One of the corporations, Westsphere, entered into an expense reimbursement plan with the LLC under which the corporation agreed to provide health insurance for LLC employees and reimburse them for expenses of diagnostic medical procedures at specified medical facilities. The second corporation was to provide

financial management services to the LLC. The taxpayer had little understanding of the purpose of the corporations that were created on the advice of his CPA. The taxpayer's Medicare and Medicaid billings (a small portion of his practice) were done as an individual practitioner. The corporations did not independently undertake business activities. The court (Judge Halpern) held that neither corporation was formed with a purpose equivalent to business activity under the test of *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), nor did either corporation undertake business activity. The court disregarded both entities. As a consequence, the taxpayer's LLC was a single member entity disregarded for federal tax purposes. Net income of the LLC, including amounts paid to the corporations, was taxable to the taxpayer. The court also upheld accuracy related penalties under § 6662(a), holding that the taxpayer's reliance on the advice of his CPA to produce employment tax savings that were too good to be true was not reasonable. The court indicated that the taxpayer failed to exercise ordinary business care by failing to question an arrangement that purported to minimize his taxes "while effecting virtually no change in the conduct of his medical practice."

2. **Asset management joint venture is not a partnership, so take that ordinary income.** Rigas v United States, 107 A.F.T.R.2d 2011-2046 (S.D. Tex. 5/2/11). Hydrocarbon Capital, LLC, which held a number of oil and gas industry financial assets, entered into a loan management and servicing agreement (specifically stating the arrangement was not a partnership) with Odyssey Energy Capital I, LP, formed by five individual limited partners with an LLC general partner. The management agreement provided for a performance fee representing 20 percent of profits after provisions for disposition of income realized on the asset portfolio designed to recoup Hydrocarbon's expenses, the capital value of the portfolio and a 10 percent preferred return. In a claim for refund, the taxpayer, one of Odyssey's limited partners, claimed pass-through capital gain treatment on gains from disposition of the managed assets. The District Court (Judge Ellison) agreed with the IRS determination that the income to the Odyssey partners was ordinary income as a service fee rather than pass-through partnership income from a joint venture with Hydrocarbon. The court indicated that notwithstanding the unambiguous text of the management agreement eschewing partnership status, it may still look to the conduct of the parties to determine whether the arrangement was a partnership. The court indicated that the Odyssey partners contributed both capital and services to the relationship with Hydrocarbon, and the arrangement provided for a profit sharing and some risk of loss for the Odyssey partners, which supported treating the arrangement as a partnership. Odyssey maintained significant management responsibility for the Hydrocarbon assets, but it did not have authority to withdraw funds from Hydrocarbon bank accounts, it could not increase Hydrocarbon's capital commitment to a particular asset, it could not enter into binding agreements in Hydrocarbon's name, and it could not dispose of an asset without Hydrocarbon's written approval. Odyssey did not share control over bank accounts that corresponded to companies in the asset portfolio, nor could it disburse funds from the accounts, and thus lacked control over the assets and income of the venture. Finally, the court pointed to the fact that neither Hydrocarbon nor Odyssey filed tax returns treating the arrangement as a partnership. Thus, the court found that the IRS established by a preponderance of the evidence that a partnership did not exist.

• The court also held that it had jurisdiction to consider the taxpayer's refund claim under TEFRA as a partner item based on its holding that the taxpayers' amended returns qualified as a partner Administrative Adjustment Request as being in substantial compliance with the requirements of Reg. § 301.6227(d)-1, notwithstanding the absence of a timely filed form 8802 as required by the regulations.

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

1. **Tax law firm misses on its own special allocation.** Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. No. 7 (2/9/11). The taxpayer law firm practiced tax law in a Kansas limited liability partnership. The partnership consisted of the three lawyers in the firm plus a subchapter S corporation wholly owned by an ESOP whose beneficiaries were the three attorney partners. For the partnership's 2004 tax year the partnership allocated 87.557% of the law firm's net business income to the S corporation partner. K-1s filed

for the 2004 year showed each attorney partner with a 30% profit and loss interest and a 10% profit and loss interest for the S corporation. Capital interests were reported as 33.3% for each attorney partner. The taxpayer could not produce a written partnership agreement for the 2004 tax year. The firm amended its partnership agreement in 2005 to eliminate the S corporation partner and allocate partnership income among the three attorneys under a formula that reflected income from the individual clients of each attorney, which was accepted by the IRS. The court (Judge Jacobs) held that the taxpayer failed to meet its burden to establish the allocation of income in the face of the missing partnership agreement for 2004. The court did not accept the taxpayer's assertion that the amended 2005 agreement provided evidence of the 2004 provisions. As a consequence, the court determined the partners' share of 2004 partnership income taking into account the facts and circumstances to identify the partners' distributive shares. The court affirmed the IRS reallocation of income in accord with the partners' capital and profits interests absent the special allocation. See another issue in this case at XI.A., below.

2. **Section 47 historic rehabilitation credits were allowed to an LLC (taxed as a partnership) in which Pitney Bowes was a 99.9 percent member despite an IRS challenge under the anti-abuse provisions of Reg. § 1.701-2.** Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. 1 (1/3/11). The Tax Court (Judge Goeke) held that the ownership interest on the historic East Hall of the Atlantic City Boardwalk Hall under a 35-year lease belonging to the New Jersey Sports and Exposition Authority could be transferred to Historic Boardwalk Hall, LLC, in which Pitney Bowes (through a subsidiary and an LLC) was the 99.9 percent member (and the NJSEA was the 0.1 percent member). Along with ownership went the § 47 Federal tax credit of 20 percent of the qualified rehabilitation expenditures incurred in transforming the run-down East Hall from a flat-floor convention space to a "special events facility" that could host concerts, sporting events and other civic events. Pitney Bowes became the 99.9 percent member of Historic Boardwalk Hall, LLC, following an offering memorandum sent to 19 large corporations, which described the transaction as a "sale" of tax credits (although that description was not repeated in any of the subsequent documents relating to the transaction). NJSEA lent about \$57 million to Historic Boardwalk Hall and Pitney Bowes made capital contributions of more than \$18 million to that LLC, as well as an investor loan of about \$1.2 million. In that offering memorandum, losses were projected over the first decade of operation of East Hall. The IRS argued that the bulk of the Pitney Bowes contributions were paid out to NJSEA as a "development fee" and that the entire transaction was a sham because NJSEA was going to develop East Hall regardless of whether Pitney Bowes made its capital contributions and loan.

- Judge Goeke held that one of the purposes of § 47 was "to encourage taxpayers to participate in what would otherwise be an unprofitable activity," and the rehabilitation of East Hall was a success, leading to the conclusion that Historic Boardwalk had objective economic substance. He also held that Pitney Bowes and NJSEA, "in good faith and acting with a business purpose, intended to join together in the present conduct of a business enterprise" and that while the offering memorandum used the term "sale," "it was used in the context of describing an investment transaction." Finally, Judge Goeke used Reg. § 1.701-2(d), Example (6), involving two high-bracket taxpayers who joined with a corporation to form a partnership to own and operate a building that qualifies for § 42 low-income housing credits, to conclude that Reg. § 1.701-2 did not apply to the Historic Boardwalk transaction because that regulation "clearly contemplate[s] a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them . . . to [a taxpayer] who can . . ."

- Query whether "economic substance" requirements are applicable when the tax benefits take the form of tax credits enacted to encourage specific types of investments?

3. **State rehabilitation tax credits for sale, or not.** Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, T.C. Memo. 2009-295 (12/21/09). The Virginia Historic Rehabilitation Credit Program contains an allocation provision that allows a developer partnership to allocate state rehabilitation tax credits to partners in proportion to their ownership interests in the partnership or as the partners mutually agree. The taxpayer partnership was a state

tax credit partner in partnerships developing historic rehabilitation projects in Virginia. The taxpayer limited partnership, as a state tax credit partner, held a small percentage ownership interest in Virginia rehabilitation projects but was allocated most of the rehabilitation tax credits that the developer partnership could otherwise not use. The taxpayer partnership also purchased state tax credits under a one-time transfer provision. The taxpayer in turn received capital contributions from 282 investor limited partners (either directly or through a lower-tier LLC or LP). The pooled capital was invested in various developer rehabilitation partnerships. The Virginia State Rehabilitation credits were allocated to the investor partners. In general each investor was allocated \$1 of state tax credit for each \$0.74 invested. The investors were “bought out after the partnerships accomplished their purpose.”

- The court (Judge Kroupa) rejected the IRS’s alternative assertions that the partnership derived income from the sale of state tax credits to the investors who were not partners, or if the investors were to be recognized as partners in the tax credit partnerships, the transactions constituted disguised sales of the state tax credits under § 707(a)(2)(B). The court was impressed by several elements of the transactions in determining that the investors created a community of interest in profits and losses by joining together for a business purpose: the parties agreed to form a partnership, they acted as partners, the parties pooled resources in that the investors’ contributed capital and the general partners contributed capital and services, and that the partners had a business purpose in terms of deriving a net economic benefit from state income tax savings (which was not a federal tax savings). The court further held that the substance of the transactions was the formation of a partnership rather than the sale and purchase of the state tax credits in part because the transaction was compelled by the form of investment specified by the Virginia program that encouraged the use of partnerships as a vehicle for attracting capital into historic rehabilitation. Rather than treating the investors as purchasers of state tax credits, the court concluded that the investors’ funds were pooled to facilitate investments in developer partnerships and that the investors remained as participants in the partnerships until the developer partnerships completed rehabilitation projects.

- The court also found that the investors bore a risk that the developer partnerships would fail to generate rehabilitation credits. The court rejected the IRS’s § 707(a)(2)(B) argument for similar reasons. The court concluded that the substance of the transactions reflects valid contributions and allocations rather than sales based upon the court’s findings that the investors made capital contributions in furtherance of the partnership’s purpose to invest in developer partnerships engaged in historic rehabilitation and to receive state tax credits, the partnerships were able to participate because of the investors’ pooled capital, the state tax credits were allocated to the investors consistent with the allocation provisions of the Virginia program, and that the investors were subject to the entrepreneurial risks of the partnerships operations. See Reg. § 1.707-3(b)(1). Finally, the court held that since the partnership did not have unreported income from the sale of state tax credits, the three year statute of limitation barred assessment and was not subject to extension to six years under § 6229(c)(2) because of an omission of 25 percent of gross income.

- One of the taxpayer’s lawyers is a former student of Professor McMahon in the University of Florida College of Law Graduate Tax Program. [PAID ADVERTISEMENT.]

- a. **The Fourth Circuit reversed *Virginia Historic* and found that there was, indeed, a sale -- albeit one that was disguised. Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 (4th Cir. 3/29/11).** On appeal, the Fourth Circuit (Judge Duncan) reversed the Tax Court opinion and found that the alleged capital contributions were disguised sales under § 707(a)(2)(B) and Reg. § 1.707-3 and should have been reported by the funds as income. The court did not decide whether “bona fide” partnerships existed, but held that the IRS properly recharacterized the transactions as sales based upon § 707, which “prevents the use of the partnership provisions to render nontaxable what would in substance have been a taxable exchange if it had not been ‘run through’ the partnership.” As it was strengthened in 1984, § 707(a) provides that “[i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall . . . be considered as

occurring between the partnership and one who is not a partner.” Under § 707(a)(2)(B), non-partnership-capacity transactions include the situation where:

- (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
- (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
- (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property.

• There is a cross-reference in Reg. § 1.707(b)-6(a) to Reg. § 1.707-3, which requires an evaluation of all the facts and circumstances to determine whether the transfer of money or other consideration would not have been made *but for* the transfer of property; and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Transfers made within two years of one another are presumed to be sales. Reg. § 1.707-3(b)(2) lists ten factors to be considered, five of which were relevant to this case. They are:

- i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- (ii) That the transferor has a legally enforceable right to the subsequent transfer;
- (iii) That the partner’s right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured; \*\*\*
- (ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner’s general and continuing interest in partnership profits; and
- (x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

• The court further held that the tax credits in question were property, looking to the substance of state law and not to labels given by, or conclusions drawn from these labels.

• It further held that any entrepreneurial risks to the investors were “both speculative and circumscribed,” continuing “that the only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery.” This conclusion was based upon the investors being promised a fixed rate of return, they did not expect any allocations of partnership income, gains or losses, and they were promised refunds if the tax credits were not delivered.

**4. Even this Tax Court Judge’s gullibility has limits. A “should” opinion by PWC that the transaction was not a disguised sale isn’t worth the paper it was printed on, which resulted in a penalty of \$36,691,796. Reliance on an opinion issued by an advisor who was actively involved in developing and structuring a transaction was unreasonable because the advisor faced an inherent conflict of interest. Canal Corp. v. Commissioner, 135 T.C.199 (8/5/10). In 1999, a member of the taxpayer’s consolidated group that manufactured tissues, WISCO, contributed substantially all of its assets to an LLC in exchange for a 5-percent interest in the LLC, which assumed most of WISCO’s liabilities and which simultaneously distributed \$755 million of cash to WISCO. The remaining 95 percent interest in the LLC was owned by Georgia Pacific. The \$755 million was obtained through a bank loan to the LLC guaranteed by Georgia Pacific, for which WISCO provided a circumscribed indemnity regarding the principal, but not the interest (which required Georgia Pacific first to look to the LLC’s assets and which also provided WISCO an increased interest in the LLC if it paid the indemnity). WISCO used the cash to pay a \$151 million dividend to Canal and repay intercompany loans. WISCO’s only assets thereafter were a \$151 note from Canal and a \$6 million corporate jet.**

Subsequently, the LLC borrowed funds from a subsidiary of Georgia Pacific to retire the bank loan. The taxpayer received a “should” opinion from PWC that the 1999 transaction would not be treated as an asset sale and gain would be deferred, for which it paid a flat fee of \$800,000. The fee was due only if the opinion was a “should” opinion, and only upon the closing of the joint venture transaction. In 2001, WISCO sold its LLC interest to Georgia Pacific for \$1 million, and Georgia Pacific then sold the entire interest in the LLC to an unrelated party. The taxpayer treated the 1999 transaction as a contribution to the LLC and the receipt of a “debt-financed transfer of consideration,” for which Reg. § 1.707-5(b) provides an exception to the disguised sale rules to the extent the distribution does not exceed the distributee partner’s share of the partnership liabilities under § 752. (However, for financial accounting purposes taxpayer reported the transaction as a sale.) The IRS asserted that the 1999 transaction was a disguised sale under § 707(a)(2)(B), because WISCO did not have any allocable share of the liability. The taxpayer argued that WISCO’s indemnity of Georgia Pacific’s guaranty imposed the economic risk of loss for the LLC debt on WISCO, and thus WISCO’s share of the debt equaled the distribution. The IRS asserted that WISCO’s indemnity agreement should be disregarded under the anti-abuse rule for allocation of partnership debt: Reg. § 1.752-2(j)(1) and (3) provides that a partner’s obligation to make a payment may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s risk of loss or to create a facade of the partner’s bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. The Tax Court (Judge Kroupa) agreed with the IRS that the transactions had to be viewed together and they constituted a disguised sale under § 707(a)(2)(B) rather than a tax-free contribution to a partnership under § 721. Taking into account all of the facts, including the facts that (1) Georgia Pacific did not require the indemnity, but it was included because the taxpayer’s tax advisor concluded that it was necessary in order to avoid the disguised sale rules, (2) the indemnity’s provisions minimized the likelihood that it would ever be invoked, and (3) the taxpayer’s representations to Moody’s and Standard & Poor’s that the only risk associated with the transaction was the tax risk, Judge Kroupa found that the indemnity agreement was crafted to limit any potential liability to WISCO’s assets, which were insufficient to cover more than a small fraction of the indemnity. Accordingly, the indemnity agreement was disregarded, and the distribution of cash to WISCO was not protected by the debt-financed transfer exception to the disguised sale rules. The 1999 transaction was a sale of WISCO’s assets. The court said, “Chesapeake [taxpayer’s predecessor] used the indemnity to create the appearance that WISCO bore the economic risk of loss for the LLC debt when in substance the risk was borne by GP.” Among the circumstances considered by the court was that Chesapeake represented that its only risk on the transaction was the tax risk.

• Judge Kroupa also upheld the imposition a substantial understatement penalty under § 6662(a) in the amount of \$36,691,796. Even though the taxpayer received a “should” opinion from PWC that the 1999 transaction would not be treated as an asset sale and gain would be deferred, the “reasonable cause exception of § 6664(c)(1) did not apply, because (1) “the opinion was riddled with questionable conclusions and unreasonable assumptions,” and (2) PWC was actively involved in planning the transaction and its opinion was tainted by a conflict of interest, which caused it have “crossed over the line from trusted adviser for prior accounting purposes to advocate for a position with no authority that was based on an opinion with a high price tag—\$800,000.” She described the opinion as “littered with typographical errors, disorganized and incomplete.” Judge Kroupa concluded that PWC’s opinion was based on the size of its fee, rather than on legal reasoning, stating as follows:

We are also nonplused by Mr. Miller’s failure to give an understandable response when asked at trial how PWC could issue a “should” opinion if no authority on point existed. He demurred that it was what Chesapeake requested. The only explanation that makes sense to the Court is that no lesser level of comfort would have commanded the \$800,000 fixed fee that Chesapeake paid for the opinion.



- Judge Kroupa found that the taxpayer “essentially bought an insurance policy as to the taxability of the transaction,” and continued to conclude as follows:

PWC’s opinion looks more like a quid pro quo arrangement than a true tax advisory opinion. If we were to bless the closeness of the relationship, we would be providing carte blanche to promoters to provide a tax opinion as part and parcel of a promotion. Independence of advisers is sacrosanct to good faith reliance. We find that PWC lacked the independence necessary for Chesapeake to establish good faith reliance. We further find that Chesapeake did not act with reasonable cause or in good faith in relying on PWC’s opinion.

- Apparently, the opinion described by the court as “littered with typographical errors, disorganized and incomplete” was a draft of an internal PWC memorandum. There appear to have been three separate final PWC opinions, prepared by two different partners, none of which contained typographical errors and were organized or were incomplete. See language in *United States v. Boyle*, 469 U.S. 241 (1985) (“When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a ‘second opinion,’ or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.”).

- The involvement of Salomon Smith Barney in the planning stages may have affected the court’s decision to uphold the asserted penalty.

- The case was settled for \$2 million during the pendency of Canal’s bankruptcy proceedings at which there were \$4 million available for unsecured creditors.

5. **DAD follows the Son of Boss into the tax shelter abyss.** Superior Trading, LLC v. Commissioner, 137 T.C. No. 6 (9/1/11). This case involves a so-called distressed asset/debt (DAD) tax shelter structure created by John Rogers, tax lawyer and purported international finance expert. The court (Judge Wherry) described the structure by noting that, “true to the poet’s sentiment that ‘The Child is father of the Man,’ the DAD deal seems to be considerably more attenuated in its scope, and far less brazen in its reach, than the Son-of-BOSS transaction.” At the top of Rogers’ pyramid, Warwick Trading, LLC, acquired uncollectable receivables from a bankrupt Brazilian retailer under a contribution arrangement. Warwick claimed a transferred basis in the receivables equal to their face value under § 723. The receivables were then contributed through multiple tiers of trading companies, interests in which were sold to individual investors. Not long after the contribution transaction, the interest of the Brazilian retailer in Warwick was redeemed, but no § 754 election to adjust basis under § 743(b) was made. Ultimately the individual investors claimed loss deductions though their interests in the trading company partnerships as the receivables were liquidated at their depreciated value through an accommodating party. These transactions occurred before the October 2004 revisions to §§ 704(c), 734 and 743 (requiring allocations of built-in loss only to the contributing party, limiting basis to FMV at the time of contribution, and requiring mandatory basis adjustments on distributions involving substantial basis reductions). The court found multiple grounds on which to undo these transactions.

- First, the court held that the original contribution of the receivables was not a partnership transaction under § 721 with § 723 transferred basis, but was instead a sale. The court concluded that the Brazilian retailer was never a partner in a partnership with a joint-profit motive, and thus the transfer of the receivables in the initial transaction was not a § 721 contribution to a partnership.

- The Brazilian retailers’ receipt of money within two years of the transfer of the receivables supported recharacterization of the transaction as a sale under § 707(a)(2)(B).

- From the Brazilian retailer’s financial statements the court found that the receivables had a zero basis at the time of the contribution in any event.

- And if that was not enough, the court collapsed the transaction under the step-transaction doctrine into a single transaction that consisted of a sale of the receivables for the amount of cash payments eventually made to the Brazilian retailer on redemption of its interest. Thus, Warwick's basis in the receivables was no higher than the cash payment, which the taxpayer failed to substantiate resulting in a zero basis.

- Interestingly, the court concluded that it was not necessary to address the broad judicial economic substance doctrine that the courts had used to disallow the tax benefits of the Son-of-Boss cases. The court said that, "Because of a DAD deal's comparatively modest grab and highly stylized garb, we can safely address its sought-after tax characterization without resorting to sweeping economic substance arguments" and added that, "we need only look at the substance lurking behind the posited form, and where appropriate, step together artificially separated transactions, to get to the proper tax characterization."

- All of that was followed by an accuracy related penalty under § 6662.

**C. Distributions and Transactions Between the Partnership and Partners**

**D. Sales of Partnership Interests, Liquidations and Mergers**

**E. Inside Basis Adjustments**

**F. Partnership Audit Rules**

**1. Partner's outside basis in a tax-shelter partnership is a partner item.** Napoliello v. Commissioner, T.C. Memo. 2009-104 (5/18/09). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. The Tax Court previously had held in Petaluma FX Partners, LLC v. Commissioner, 131 T.C. 84 (2008), that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. In the instant case, the court (Judge Kroupa) agreed with the IRS that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that it had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. The court thus proceeded to determine that the taxpayer claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment. The Tax Court also held that the FPAA gave the taxpayer fair notice of the IRS claims.

**a. Part of the Tax Court's holding in Petaluma FX Partners retains its vitality, but not the part the Tax Court relied upon in Napoliello.** Petaluma FX Partners, LLC v. Commissioner, 591 F.3d 649 (D.C. Cir. 1/12/10). The Tax Court in this Son-of-Boss tax shelter case determined that it had jurisdiction in a TEFRA partnership proceeding to determine that the partnership lacked economic substance and was a sham. Since the partnership was disregarded, the Tax Court concluded that it had jurisdiction to determine that the partners' outside basis in the partnership was zero. The Tax Court reasoned that a partner could not have a basis in a partnership interest that did not exist. (131 T.C. No. 9 (2008).) The Court of Appeals agreed that the Tax Court had jurisdiction in the partnership proceeding to determine that the partnership was a sham. Temp. Reg. § 301.6223-1T(a) expressly provides that, "[a]ny final partnership administrative adjustment or judicial determination ... may include a determination that the entity is not a partnership for such taxable year." The Court of Appeals held that the regulation was explicitly authorized by § 6233. A partnership item is defined in § 6231(a)(3) as

an item required to be taken into account in determining the partnership's income under Subtitle A of the Code that is identified in regulations as an item more appropriately taken into account at the partnership level. The court indicated that, "Logically, it makes perfect sense to determine whether a partnership is a sham at the partnership level. A partnership cannot be a sham with respect to one partner, but valid with respect to another." However, the Appeals Court concluded that the partners' bases were affected items, not partnership items, and that the Tax Court did not have jurisdiction to determine the partners' bases in the partnership proceeding. The court rejected the IRS argument that the Tax Court had jurisdiction in the partnership proceeding to determine the partners' outside basis as an affected item whose elements are mainly determined from partnership items. The court held that resolution of the affected item requires a separate determination at the partner level even though the affected item could easily be determined in the partnership proceeding. Finally, the Court of Appeals held that accuracy related penalties under § 6662(a) could not be determined without a determination of the partners' outside basis in a partner level proceeding and vacated and remanded the Tax Court's determination of penalty issues.

b. On remand, the Tax Court disavowed jurisdiction over penalties in the partnership-level proceeding. *Petaluma FX Partners, LLC v. Commissioner*, 135 T. C. 581 (12/15/10). The court (Judge Goeke) held that in light of the Court of Appeals holding that determination of adjustments attributable to the partner's outside basis is an affected item properly addressed in individual partner level proceedings, any § 6662 penalties must also be determined at the partner-level proceeding and that the Tax Court had no jurisdiction to assess the penalties. The court rejected the IRS argument that the penalties proceeded from the partner-level determination that the partnership was a sham, thereby providing jurisdiction for the Tax Court to determine the negligence penalty. The Tax Court held that if a penalty "does not relate directly to a numerical adjustment to a partnership item, it is beyond our jurisdiction. In this case there are no such adjustments to which a penalty can apply." Judge Halpern dissented, asserting that the Tax Court could reconsider the penalty on grounds other than the partners' outside bases under the court's initial findings that the partnership was a sham and did not provide the basis increase claimed by the partners. A dissent by Judge Marvel (joined by three others) argued that the Tax Court has jurisdiction to determine the imposition of a penalty for negligence related to adjustment of a partnership item in the partnership level proceeding, but the amount of the individual penalty depends upon a computation at the partner level.

c. **Partner's outside basis in a tax-shelter partnership is a partner item.** *Napoliello v. Commissioner*, 108 A.F.T.R.2d 2011-5902 (9th Cir. 8/23/11). The taxpayer invested in a Son-of-Boss transaction involving digital foreign currency items. The IRS issued an FPAA to the taxpayer as a notice partner. In the uncontested partnership proceeding it was determined that the partnership was a sham that lacked economic substance, that transactions entered into by the partnership should be treated as transacted directly by the partners, and that purported losses claimed on disposition of distributed property with an enhanced basis should be disallowed. The IRS assessed a deficiency against the taxpayer based on the partnership items. Upholding the Tax Court, the Ninth Circuit joined the D.C and Eighth Circuits, *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010); *RJT Invs. X v. Commissioner*, 491 F.3d 732 (8th Cir. 2007), holding that the determination of whether a partnership was a sham that will be disregarded for Federal tax purposes is a partnership item. The Ninth Circuit also agreed with the Tax Court that the partner's basis in distributed securities from the sham partnership is an affected item subject to determination in the partnership proceeding, and not subject to re-determination in the partner-level deficiency proceeding. Because the amount of any loss with respect to the partner's disposition of securities distributed from the partnership required a factual determination at the partner level, the court held that the Tax Court had jurisdiction in the partner deficiency proceeding to proceed under normal deficiency procedures. Thus, the Tax Court could determine that the taxpayer's claimed loss on the sale of the distributed securities was disallowed, that the taxpayer's basis in the securities was their direct cost rather than an exchange basis from the partnership interest, and that the taxpayer was not allowed to deduct transaction costs attributable to the investment.

2. Krause v. United States, 105 A.F.T.R.2d 2010-1899 (W.D. Tex. 1/22/10). Partners who didn't contest an FPAA were not permitted to raise partnership level defenses to § 6662(h) valuation misstatement penalties in a separate refund action. The taxpayer's claim that a valuation misstatement penalty is not allowable with respect to a disallowed partnership deduction is a substantive defense that must be raised in the partnership proceeding. The assertion does not constitute a computational error or partner-level defense permitted in a refund action under § 6230(c).

a. **Affirmed.** Krause v. United States, 398 Fed. Appx. 35 (5th Cir. 10/12/10). The court held in a per curiam opinion that the penalties assessed in the FPAA were attributable to the "fraudulent" loss the partnership alleged it incurred when it sold high basis Canadian currency, which passed through to the taxpayer. Thus, the penalties "related to basis, basis adjustments, and losses, all of which are considered partnership items under § 6231."

3. **The applicable statute of limitations is a partnership item, even on the second try.** Prati v. United States, 603 F.3d 1301 (Fed. Cir. 5/5/10). The taxpayers invested in tax shelters promoted by AMCOR in the mid-1980s. In a partnership audit procedure, following issuance of an FPAA, the Tax Court held rejected partnership assertions that the FPAA was barred by the statute of limitations. *Agri-Cal Venture Associates v. Commissioner*, T.C. Memo 2000-271. Some of the 43 partnerships entered into a settlement agreement with the IRS that allowed a percentage of ordinary deductions, but provided that the IRS may assert additional tax liability against individual partners plus interest. Subsequently the IRS assessed additional tax plus penalties against the taxpayers, which they paid in full. Seventy-seven of 129 AMCOR partnership tax refund cases filed in the Court of Federal Claims were identified as being factually similar raising claims that the statute of limitations had expired and that assessments of additional interest under § 6621(c) were improper because the transactions were not tax-motivated transactions. *Prati* was selected as a representative case. The trial court dismissed the action accepting the IRS assertion that the court lacked jurisdiction to consider the claims that represented partnership items that should have been challenged in the partnership level proceeding. Ultimately 57 cases were appealed but stayed pending the court's decision in *Keener v. United States*, 551 F.3d 1358 (Fed. Cir. 2009), which held that the statute of limitations is a partnership item as defined in § 6231(a), and that whether a partnership transaction is a sham is a partnership item for purposes of the additional interest provision. In *Keener* the court rejected a claim that the FPAA was untimely under § 6229 (three years after the date a partnership return is filed or the last day for filing the partnership return), but did not address a separate assertion that the claim was barred by the general three year limitation of § 6501 (three years from the date an individual's return is filed). Notwithstanding representations by the taxpayers before *Keener* was decided that the case would be determinative, the Federal Circuit considered the § 6501 argument, but reached the same result. The court concluded that the reasoning in *Keener* was directed to statutes of limitation in general and was not limited to § 6229. The court also applied the reasoning of *Keener* to the taxpayers' § 6621(c) interest claim to hold that the characterization of partnership transactions is a partnership item. The court rejected the assertion that the taxpayers' settlement agreements converted the items into non-partnership items.

a. Kercher v. United States, 106 A.F.T.R.2D 2010-7097 (D. Tex. 11/16/10). In a proceeding involving a representative seven partnership level proceedings against tax shelter investors in 43 deals promoted by American Agri-Corp (AMCOR), the Tax Court rejected statute of limitations defenses raised by the partnerships in *Agri-Cal Venture Associates v. Commissioner*, T.C. Memo. 2000-271. Each of the 43 partnerships stipulated it would be bound by the decision. In separate actions by individual partners, the District Court (Magistrate Judge Mazzant) held that under *Prati*, the statute of limitations argument had been decided in partner level proceedings and that the individual partners were barred from asserting the argument in individual refund claims. The court also rejected the taxpayer's argument that they were barred from raising the statute of limitations issue in the partnership proceeding.

4. **The \$9,500 deposited was only \$2.9 million short; that's a reasonable mistake.** Kislev Partners v. United States, 84 Fed. Cl. 385 (8/13/08). The taxpayer, a non-tax matters partner, filed an action seeking review of a final partnership administrative adjustment

for Kislev Partners, which claimed \$140 million of losses in an abusive tax shelter known as a distressed asset/debt transaction (DAD). In order to invoke jurisdiction in the Court of Federal Claims, a filing partner is required under § 6226(e)(1) to make a deposit of the amount by which the taxpayer's tax liability would be increased if the partner's return were filed consistent with the treatment of partnership items in the FPAA. In this case the taxpayer made a deposit of \$9,500 reflecting the taxpayer's potential tax liability for the year in which the claimed losses were passed through from the partnership. The taxpayer did not calculate the deposit based on the taxpayer's liability for years to which he carried over the losses. The correct amount of the deposit, including claimed tax reductions in the carryover years was \$2,905,046, exclusive of penalties and interest. The court held that the deposit amount is to be calculated over multiple taxable years. However, the court was satisfied that the taxpayer made a good faith effort to determine the deposit under the statute and denied the government's motion to dismiss, as long as the taxpayer has made the additional deposit within 60 days of the date of the opinion.

**a. Go figure the deposit and come back.** Russian Recovery Fund Ltd. v. United States, 90 Fed. Cl. 698 (12/14/09). Section 6226(a) requires that in order to petition for a readjustment of a partnership item in the Court of Federal Claims, the petitioning partner must provide a deposit of the amount by which the tax liability of the petitioning partner would be increased if the treatment of partnership items on the partner's return were consistent with the FPAA. Reg. § 301.6226(e)-1(a)(1) requires that if the petitioning partners is itself a partnership, the deposit must include the potential liability of each indirect partner. In an arrangement with losses flowing to partners through multiple partnerships, the court holds that the deposit must be calculated by any downstream partner to include losses flowing through the chain of partnerships, and not just losses passing through a single filing partnership. The filing partner's \$50,000 actual deposit was increased to a required deposit of \$8 million under this interpretation. Rather than dismiss the case, however, the court allowed the taxpayer to show that she made a good faith effort to calculate the required deposit.

**b. Different judge, the Court of Federal Claims reaches a different result opening the jurisdictional door to easier entry.** Prestop Holdings, LLC v. United States, 96 Fed. Cl. 244 (12/7/10). In both Russian Recovery Fund, Ltd. v. United States, 90 Fed. Cl. 698 (12/14/09) and Kislev Partners, L.P. v. United States, 84 Fed. Cl. 385 (8/13/08), the court interpreted § 6226(e)(1) as requiring a deposit based on the partner's entire multi-year increase in tax liability. The taxpayer in Prestop was a grantor trust partner that claimed losses from partnership short sale transactions of approximately \$2.6 million, most of which were carried over to later taxable years. Rejecting the analysis of both Russian Recovery and Kislev Partners, the court (Judge Allegra) concluded that the specific language of § 6226 along with multiple indications throughout the TEFRA provisions indicated that the provisions applied to a single tax year under the annual accounting system. Thus, the court held that the full payment requirement of § 6226(e)(1) applied only to the tax years for which the taxpayer was seeking a refund. As a result, the taxpayer's \$100 deposit was adequate to establish jurisdiction in the court to consider the taxpayer's challenge to administrative adjustments in the partnership return for the year in which the full loss was passed to the taxpayer trust.

**5. The Tax Court finds jurisdiction to address § 6662 penalties in this Son-of-Boss TEFRA partnership proceeding. Taxpayer's reasonable cause defense was rejected because advisors were promoters and the opinion was sloppy.** 106 Ltd. v. Commissioner, 136 T.C. 67 (1/10/11). The taxpayer's tax matters partner responded to Ann. 2004-46, 2004-1 C.B. 964, and filed an amended return removing losses attributable to a Son-of-Boss transaction promoted by Joe Garza. The IRS issued an FPAA to the partnership that adjusted partnership items and asserted penalties. In prior proceedings that Tax Court issued orders granting summary judgment to the IRS on the substantive partnership issues and the presence of a gross valuation misstatement. In this proceeding the court (Judge Holmes) held that the Tax Court had jurisdiction to determine whether the partnership had a reasonable cause defense based on reliance on opinion of counsel, but that the reliance itself was not reasonable. The court concluded that the decision in Petaluma FX Partners v. Commissioner, 591 F.3d 649 (D.C. Cir. 2010) holding the Tax Court did not have jurisdiction in a partnership proceeding to

determine the partners' outside basis or whether penalties were applicable to the outside basis issues did not bar jurisdiction to adjudicate a reasonable cause defense where outside basis is not at issue. Following *Am. Boat Co., LLC v. United States*, 583 F.3d 471, 480 (7th Cir. 2009), and similar authorities, the court held that it had jurisdiction in a partnership proceeding to consider entity level defenses to the accuracy-related penalty. Nonetheless, the court rejected the reasonable cause defense finding that the partnership could not in good-faith rely on advisors who were promoters of the transaction. In addition, the court found that the tax-matters partner entered into a "tax strategy" with the intent to "lose money", which combined with the sloppy opinion and the tax-matters partner's unusual experience demonstrated a lack of good faith reliance.

**6. Son of Jade Trading finds that penalties based on a partner's basis are a partner item.** *Jade Trading, LLC v. United States*, 1057 A.F.T.R.2d 2011-1832 (Fed. Cl. 4/29/11). In affirming the Court of Federal Claims's determination that the taxpayers' Son of Boss transaction lacked economic substance the Court of Appeals for the Federal Circuit remanded the case for a determination as to whether penalties could be imposed without relying on individual partners' outside basis, which is not a partnership item. *Jade Trading, LLC v. United States*, 598 F.3d 1372, 1381 (Fed. Cir. 2010). Section 6226(f) confers jurisdiction in a partnership proceeding to determine penalties that relate to an adjustment of a partnership item. Partnership item is defined in § 6231(a)(3) as an item required to be taken into account under any provision of subtitle A to the extent that regulations provide that the item is more appropriately determined at the partnership level. In the Son of Boss transactions, various options contracts are structured to permit a distribution of property (usually foreign currency) with an artificially high basis determined from the outside basis of a liquidated partnership interest. Tax deficiencies resulted from denying losses claimed using the partners' outside basis transferred to distributed assets. Relying on *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), the court pointed out that, even though the partnership proceeding determined that the partnership was a sham, which is a partnership item, the resulting effect on the partner's outside basis remains a partner item not within the jurisdiction of the partnership proceeding. The court rejected the IRS argument that the determination that the partnership was a sham and that the option spread transaction lacked economic substance was converted into a finding that something other than the partners' outside bases justified penalties as the partnership level. The court also rejected the IRS attempt to recharacterize the litigation as denying deductions on the partnership's misstatement of a partnership item based on the partner's contributions of options rather than as basing adjustments on the partners' bases.

**7. If you pay without a statutory notice, you can't get a refund.** *Bush v. United States*, 599 F.3d 1352 (Fed. Cir. 3/31/10). During the pendency of a partnership level proceeding, the taxpayers entered into closing agreements with the IRS with respect to their § 465 at-risk amounts in the partnership. The closing agreements did not waive the right to a deficiency notice. Subsequently, the IRS issued Notices of Adjustment, without issuing any deficiency notices, based on the application of the agreed upon at-risk amount in the closing agreements. The taxpayers paid the assessed taxes and sought a refund. A deficiency notice is not required if a tax liability issue has been resolved in a partnership-level proceeding. In that case any additional tax due is assessed as a computational adjustment, § 6230(a)(1), which § 6231(a)(6) defines for this purpose as the "change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item." But a deficiency notice is required if the additional tax asserted by the IRS to be due does not involve such a "computational adjustment." Thus, a deficiency notice is required if the deficiency is attributable to "affected items which require partner level determinations." § 6230(a)(2)(A)(i). The court (Judge Dyk), held for the government, concluding that on the facts of the case, the IRS's failure to issue a deficiency notice was harmless error. After first concluding that § 6213(a) "does not broadly provide for a refund of amounts paid by the taxpayer after assessment or provide for a refund where the taxpayer voluntarily pays the assessment before collection proceedings are initiated," the court continued as follows:

The IRS did not issue a demand for payment (which is a predicate to collection, see I.R.C. § 6303) or initiate collection proceedings. The taxpayers do not ... seek repayment of funds improperly collected. Rather, the taxpayers paid the assessments and then sued for a refund, alleging that they are entitled to a refund simply because the IRS failed to issue the requisite notice, without regard to whether the tax was in fact owed, and without any showing that the taxpayers were prejudiced by litigating the tax issue in the refund proceedings rather than in the Tax Court. Nothing in the language of the statute confers such a refund right on the taxpayer, and the failure in the statute to provide for a refund under such circumstances strongly suggests that no such automatic refund was intended.

• Finally, the court explained that despite the taxpayers not having received a deficiency notice, had they not voluntarily paid the tax, they could have had their day in Tax Court simply by not paying and seeking collection due process relief under § 6330 when the IRS subsequently took actions to collect the assessed taxes.

a. **And the full court upholds the IRS, but for different reasons.** Bush v. United States, 108 A.F.T.R.2d 2001-5941 (Fed. Cir. 8/24/11). After vacating its prior decision and rehearing the case en banc, the Federal Circuit again ruled for the Government. The court held that under § 6231(a)(6) a computational adjustment may be made for any changes in a partner's tax liability that arise from the partnership proceeding regardless of whether the TEFRA proceeding makes changes to the treatment of partnership items from the partnership returns. Thus, the fact that the partnership proceeding was settled with a closing agreement permits subsequent computational adjustments to the partners without requiring a notice of deficiency. The court also held that because of the settlement, redetermining the partners' at-risk amounts did not require partner level factual determinations that would treat the adjustments as affected items requiring a partner-level notice of deficiency.

#### G. Miscellaneous

### VIII. TAX SHELTERS

#### A. Tax Shelter Cases and Rulings

1. **Another corporate tax shelter investor with a "never say die" attitude toward litigating hopeless cases. God bless their willingness to pay attorney's fees for cases that can't be won.** Wells Fargo & Co. v. United States, 641 F.3d 1319 (4/15/11). Wells Fargo was denied the tax benefits it sought from another package of fairly generic SILO transactions with tax-exempt entities involving transportation and technology equipment. The District Court had "found that the claimed tax deductions are for depreciation on property Wells Fargo never expected to own or operate, interest on debt that existed only on a balance sheet, and write-offs for the costs of transactions that amounted to nothing more than tax deduction arbitrage." Accordingly, the Federal Circuit affirmed the Court of Federal Claims determination that transactions did not pass muster under the substance over form doctrine. Judge Bryson's opinion noted:

The only flow of funds between the parties to the transaction was the initial lump sum given to the tax-exempt entity as compensation for its participation in the transaction. From the tax-exempt entity's point of view, the transaction effectively ended as soon as it began. The benefits to Wells Fargo continued to flow throughout the term of the sublease, however, in the form of deferred tax payments. The third-party lender and its affiliate were also compensated for their participation, as were the creators and promoters of the transactions. These transactions were win-win situations for all of the parties involved because free money—in the form of previously unavailable tax benefits utilized by Wells Fargo—was divided among all parties. The money was not entirely "free," of course, because it was in effect transferred to Wells Fargo from the public fisc.

2. **A Twenty First Securities tax shelter bites the dust.** Samueli v. Commissioner, 132 T.C. 37 (2009). The taxpayer entered into a tax shelter transaction planned by Twenty First Securities (of *Compaq* fame), a simplified (☺) explanation of which is as

follows. In October 2001, the taxpayer purchased fixed-income securities (Freddie Mac principal strips) from a broker (Refco) on a margin loan (Refco was entitled to hold the securities as collateral for the margin loan) and then “lent” the securities to Refco. The standard form agreement allowed the taxpayer to terminate the transaction and receive identical securities from Refco by giving notices on any business day, but an addendum overrode that provision and provided that the “loan” of the securities would terminate on January 15, 2003, or at the taxpayer’s election on July 1 or December 2, 2002. The taxpayer purchased the securities for \$1.64 billion, but immediately “lent” the securities to Refco and received cash “collateral” of \$1.64 billion, which he used to repay the margin loan. The loan contracts provided that the taxpayer was entitled to receive all interest, dividends, and other distributions attributable to the securities, but that the taxpayer was obligated to pay Refco a variable rate fee for use of the \$1.64 billion cash collateral. In December 2002, the taxpayer paid Refco \$7.8 million of “interest” on the \$1.64 billion cash collateral, which was re-lent to the taxpayer (secured by the securities, which had increased in value). The transaction terminated on January 15, 2003 and Refco was obligated to pay the taxpayer \$1.69 billion to purchase the securities in lieu of transferring them to the taxpayer. The taxpayer was simultaneously obligated to pay Refco \$1.68 billion, which reflected repayment of the \$1.64 billion cash collateral, plus accrued but unpaid variable rate fees, but the amounts were offset and Refco paid the taxpayer \$13.6 million. The taxpayer reported a \$50 million long term capital gain and deducted \$33 million of interest (cash collateral fees). Judge Kroupa held that the purported loan transaction did not satisfy the requirements of § 1058. To qualify as a loan of securities under § 1058, the loan agreement must (1) provide for the return to the lender of identical securities; (2) require payments to the lender equal to all interest, dividends, and other distributions on the securities during the period of the loan, and (3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred. If any of these conditions is not satisfied, the purported loan will be treated as a realization event. Because the taxpayer could demand return of the securities only on three specified dates, and not at any time during the term of the loan, he could not sell the securities to realize a gain at any and all times that the possibility for a profitable sale arose. Thus, the taxpayer’s opportunity for gain with respect to the transferred securities transferred was reduced. Judge Kroupa rejected the taxpayer’s argument that because the taxpayer had not surrendered all opportunity to realize a gain with respect to the securities that the third condition prerequisite to qualifying for loan treatment under § 1058 had been satisfied. The statutory test for disqualification does not require complete elimination of the benefits of ownership, but merely a reduction. As a result, the “loan” of the securities in 2001 was treated as a sale on which no gain was realized (because the basis and amount realized were identical), and the “repayment” of the securities to the taxpayer in 2003 was treated as a repurchase followed by a resale to Refco on which a \$13.5 million short term capital gain was realized. Furthermore, the taxpayer was not entitled to deduct the cash collateral fees paid as interest in connection with the purported securities lending arrangement because no debt existed. The cash transferred in 2001 represented the proceeds of the first sale and not collateral for a securities loan. Thus, no “cash collateral” was outstanding during the relevant years on which the claimed collateral fees could accrue.

a. **On appeal, every argument in the taxpayer’s kitchen sink goes down the drain.** Samueli v. Commissioner, 108 A.F.T.R.2d 2011-6270 (9th Cir. 9/15/11). In an opinion by Judge Tashima, the Ninth Circuit affirmed the Tax Court. The first sentence was worded in a manner that left no suspense: “This case requires us to decide whether a purported securities loan with a fixed term of at least 250 days and possibly as long as 450 days, entered into not for the purpose of providing the borrower with access to the lent securities, but instead for the purpose of avoiding taxable income for the lender, qualifies for nonrecognition treatment as a securities loan pursuant to § 1058 ... .” The Court of Appeals core reasoning was the same as the Tax Court’s.

The plain language of §1058(b)(3), with the gloss provided by elementary economic analysis, supports the Tax Court’s conclusion on this point. Taxpayers



relinquished all control over the Securities to Refco for all but two days in a term of approximately 450 days. During this period, Taxpayers could not have taken advantage of a short-lived spike in the market value of the Securities, because they had no right to call the Securities back from Refco and sell them at that increased price until several months later. Common sense compels the conclusion that this reduced the opportunity for gain that a normal owner of the Securities would have enjoyed.

- The court rejected the taxpayer's argument, which it labeled as "superficially appealing" that Taxpayers argue that "their inability to secure the return of the Securities on demand did not affect their ability to recognize gain because the Securities were 'zero-coupon bonds whose value [did] not widely fluctuate with windfall profits at some momentary period,'" because "when one owns \$1.6 billion of a particular security, even a small fluctuation in value can produce a significant opportunity, in absolute terms, for profit." Furthermore, "Refco's option to purchase the Securities at the LIBOR-based prices still affected Taxpayers' ability to realize the market price of the Securities on the dates when they had the option of getting them back from Refco."

- The court noted, however, that its conclusion that the transaction at issue reduced the taxpayers' opportunity for gain "does *not* necessarily imply a conclusion that a securities loan must be terminable upon demand to satisfy the requirements of § 1058(b)(3)," but declined to address the issue further, noting that additional guidance from the IRS and Treasury should deal with the issue.

- The court also rejected the taxpayer's argument that § 1058 is merely a safe harbor and even if the transaction did not qualify under § 1058, it nevertheless was a loan under general tax principles. Although the taxpayers' purchase of the securities funded by a margin loan had a non-tax business purpose, "[t]he sole motivation for adding the purported securities loan to the transaction was tax avoidance. ... Unlike a typical securities lending arrangement, this transaction was designed around minimizing Taxpayers' tax bill rather than around Refco's need to have the Securities available to deliver to its customers."

- The court also rejected the taxpayer's argument that § 1058 was irrelevant and the transaction was in substance the "liquidation" of a contract right to receive the securities from Refco, which would result in long term capital gain because the contract right was held for more than one year.

3. **Low value, high substitute basis tax shelter falls on the absence of a partnership and a lack of economic substance.** *Rovakat, LLC. v. Commissioner*, T.C. Memo. 2011-25 (9/20/11). This is a TEFRA partnership proceeding against a cookie-cutter tax shelter arrangement created by Lance O. Valdez who did business as a tax attorney and financial advisor. In this particular case, the taxpayer, Rovakat, was an LLC taxed as a partnership formed by International Capital Partners LP (ICP), a Cayman Islands partnership controlled by Valdez, and International Strategic Partners (ISP), a Delaware LLC, which was owned 99.6 percent by Mr. Hovnanian who acted as the tax matters partner for Rovakat, and the remaining interest was owned by ICP and another Valdez-controlled entity. In a series of transactions through partners in ICP, Rovakat acquired as a contribution from ICP 50,000 Swiss Francs with a fair market value of \$34,185 in which ICP then Rovakat claimed a basis of \$5.8 million. One month later, Mr. Hovnanian purchased 90 percent of ICP's interest in Rovakat for \$30,776. The next day Rovakat sold the Francs for \$30,776, and claimed a loss of \$5,769,532. The court (Judge Laro) ruled for the IRS disallowing the losses after a trial that involved 7 lay and 3 expert witnesses, 700 stipulated facts and over 600 exhibits, finding that—

- ICP, one of the Rovakat partners was not itself a partnership so that ICP's acquisition of the Francs provided it with a cost basis rather than a high transferred basis. Thus, in turn, Rovakat's basis in the Francs was only the cost basis of ICP. The court found that the ICP partners did not intend to join together to carry on a trade or business, but only to acquire tax basis in "what was otherwise a worthless shell entity."

- The transaction lacked economic substance under what the

court described as the integrated two-part analysis of the economic substance doctrine, holding on consideration of multiple factors that the various transactions had no practical economic effect apart from tax savings, and that the taxpayer did not participate in the transaction for a valid non-tax business purpose.

- The court also held that Rovakat omitted \$650,000 of gross income attributable to fees for consulting that were not offset by claimed deductions, and that this income was self-employment income subject to self-employment tax.

- To make victory complete, the court upheld § 6662 penalties indicating that the partnership's reliance on tax opinions from De Castro, West, Chodorow, Glickfield & Nass, Inc. and Sidley, Austin, Brown, and Wood LLP, was not reasonable reliance. As to the former, the court indicated that Mr. Hovnanian had no personal contact with the attorneys who wrote the opinion, and that the opinion contained material misstatements of fact. The Sidley Austin opinion was obtained by Valdez and ICP and made no reference to Hovnanian or Rovakat.

#### B. Identified "tax avoidance transactions."

1. Now let me get this straight. I followed the Code and Regs meticulously, claimed my loss deduction, but it was disallowed because I really had no possibility of actually making money on the deal and all I was looking for was a nice tax loss, and even though I've got this letter from my lawyer saying the deduction is 100% legal, I'm still looking at a 40 percent penalty on the deficiency. But my neighbor who deducted the cost of his kid's college education as a business expense, which every kindergartner knows you can't do, doesn't have to pay any penalty because he's dumb and his dumb, but probably honest, CPA said it was OK. Say What!? Well, we don't have to "know it when we see it" because Congress has defined it for us. The 2010 Health Care Reconciliation Act added new Code § 7701(o), codifying the economic substance doctrine, which has been applied by the courts for several decades as a judicial interpretive doctrine to disallow tax benefits otherwise available under a literal reading of the Code and regulations.

- **Background** — Codification of the economic substance doctrine has been on the legislative agenda many times since early in the first decade of this century, or for the past ten years (for those of us still hung up on Y2K). The move for codification was motivated in part by the insistence of not a few tax practitioners that the economic substance doctrine simply was not actually a legitimate element of the tax doctrine, notwithstanding its application by the courts in many cases over several decades. This argument was based on the assertion that the Supreme Court had never actually applied the economic substance doctrine to deny a taxpayer any tax benefits, ignoring the Supreme Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960), and instead focusing on the Supreme Court's subsequent decisions in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), in which a transaction that on the facts showed the total lack of "economic substance" was upheld. Congressional concern was intensified by the decision of the Court of Federal Claims in *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007), which questioned the continuing viability of the doctrine, stating that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," 144 (JCX-18-10 3/21/10). However, in that case the trial court found that the particular transaction at issue in the case did not lack economic substance, and thus the trial court did not actually rule on its validity, and on appeal, the Court of Appeals for the Federal Circuit vacated the Court of Federal Claims decision and, reiterating the validity of the economic substance doctrine and, in the opinion of some, expanding it greatly, held that transaction in question lacked economic substance. Although the economic substance doctrine has been articulated in a number of different manners by different courts over the years, its purpose is aptly described by the Court of Appeals for the Federal Circuit in *Coltec Industries v. United States*, *supra*.

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.

- The modern articulation of the doctrine traces its roots back to *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), where the Court upheld the taxpayer's treatment of an early version of a SILO, stating as follows:

[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

- This passage – which sets forth a statement as to what was sufficient for economic substance, but which was subsequently interpreted to be a statement as to what was necessary for economic substance<sup>1</sup> – has led courts to two different formulations of the economic substance doctrine. One, the so-called “conjunctive test” requires that a transaction have *both* (1) economic substance and (2) a non-tax business purpose in order to be respected for tax purposes. See, e.g., *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9 (2009); *Coltec, supra*. Under the other formulation, the so called “disjunctive test,” represented principally by *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001), and *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), a transaction would be respected for tax purposes if it had *either* (1) economic substance and (2) a non-tax business purpose. Yet a third articulation appeared in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), where the court concluded that, that “these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.” The courts also have differed with respect to the nature of the non-tax economic benefit a taxpayer is required to establish to demonstrate that a transaction has economic substance. Some courts required a potential economic profit. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *cert. denied*, 385 U.S. 1005 (1967). Other courts have applied the economic substance doctrine to disallow tax benefits where – even though the taxpayer was exposed to risk and the transaction had a profit potential – compared to the tax benefits, the economic risks and profit potential were insignificant. *Sheldon v. Commissioner*, 94 T.C. 738 (1990); *Goldstein, supra*. Yet other courts have asked whether a stated business benefit – for example, cost reduction, as opposed to profit-seeking – of a particular transaction was actually obtained through the transaction in question. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007). Finally, notwithstanding that several courts have rejected the bootstrap argument that an improved financial accounting result — derived from tax benefits increasing after-tax profitability — served the valid business purpose requirement, see, e.g., *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, *aff'd*, 326 F.3d 737 (6th Cir. 2003); *Wells Fargo & Company v. United States*, 91 Fed. Cl. 35 (2010), taxpayers continued to press such claims.

---

<sup>1</sup> Ira believes that the interpretation contains an error in logic which takes a statement from the *Frank Lyon* case as to what is “sufficient” for economic substance and construes it as a statement as to what is “necessary” for economic substance. Marty and Dan do not so believe, or think that the alleged error is irrelevant.

- **The Codified Economic Substance Doctrine** — The codification of the economic substance doctrine in new § 7701(o) clarifies and standardizes some applications of the economic substance doctrine when it is applied, but does not establish any rules for determining when the doctrine should be applied. According to the legislative history, “the provision [I.R.C. § 7701(o)(5)(C)] does not change present law standards in determining when to utilize an economic substance analysis.” See STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152 (JCX-18-10 3/21/10). Thus, “the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.” *Id.*, at 153. Codification of the economic substance doctrine was not intended to alter or supplant any other judicial interpretive doctrines, such as the business purpose, substance over form, and step transaction doctrines, any similar rule in the Code, regulations, or guidance thereunder; § 7701(o) is intended merely (merely?) to supplement all the other rules. *Id.*, at 155.

- **Conjunctive analysis of objective and subjective prongs** — One of the most important aspects of new § 7701(o) is that it requires a *conjunctive* analysis under which a transaction has economic substance only if (1) the transaction changes the taxpayer’s economic position in a meaningful way apart from Federal income tax effects *and* (2) the taxpayer has a substantial business purpose, apart from Federal income tax effects, for entering into such transaction. (The second prong of most versions of the codified economic substance doctrine introduced in earlier Congresses added “and the transaction is a reasonable means of accomplishing such purpose.” See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). It is not clear what difference in application was intended by adoption of the different final statutory language.) This conjunctive test resolves the split between the Circuits (and between the Tax Court and certain Circuits) by rejecting the view of those courts that find the economic substance doctrine to have been satisfied if there is either (1) a change in taxpayer’s economic position *or* (2) a nontax business purpose, see, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *IES Industries, Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001). Section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. The Staff of the Joint Committee Report indicates that the provision “does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine,” and gives as an example the courts’ ability “to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”

- **Claim of Profit Potential** — Section 7701(o)(2) does not require that the taxpayer establish profit potential in order to prove that a transaction results in a meaningful change in the taxpayer’s economic position or that the taxpayer has a substantial non-Federal-income-tax purpose. Nor does it specify a threshold required return if the taxpayer relies on the profit potential to try to establish economic substance. (In this respect the enacted version differs from earlier proposals that would have required the reasonably expected pre-tax profit from the transaction to exceed a risk-free rate of return. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003).) But if the taxpayer does rely on a profit potential claim, then the profit potential requires a present value analysis:

The potential for profit of a transaction shall be taken into account in determining whether the requirements of [the § 7701(o) test for economic substance] are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

- Thus the analysis of profit potential by the Court of Federal Claims in *Consolidated Edison Co. of New York v. United States*, 90 Fed. Cl. 228 (2009), which appears not to have thoroughly taken into account present value analysis, would not stand muster

under the new provision. In all events, transaction costs must be taken into account in determining pre-tax profits, and the statute authorizes regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. Any State or local income tax effect that is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Thus, state tax savings that piggy-back on Federal income tax savings cannot provide either a profit potential or a business purpose. Similarly, a financial accounting benefit cannot satisfy the business purpose requirement if the financial accounting benefit originates in a reduction of Federal income tax.

- **Don't worry, be happy! [?]** — Section 7701(o)(5)(B) specifically provides that the statutory modifications and clarifications apply to an individual only with respect to “transactions entered into in connection with a trade or business or an activity engaged in for the production of income.” (We wonder what else anybody would have thought they might apply to? The home mortgage interest deduction? Charitable contributions of appreciated property? How about a Son of Boss transaction where there is no possibility for profit?) More importantly, according to STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT,” 152-153 (JCX-18-10 3/21/10), “[t]he provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.” The list of transactions and decisions intended to be immunized for the application of the economic substance doctrine includes:

(1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

- Leasing transactions will continue to be scrutinized based on all of the facts and circumstances.

- **Jettisoned along the way** — Many earlier versions of the codification of economic substance doctrine, some of which were adopted by the House, also provided special rules for applying what was essentially a *per se* lack of economic substance in transactions with tax indifferent parties that involved financing, and artificial income and basis shifting. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). These rules did not make it into the enacted version. Special statutory rules for determining the profitability of leasing transactions also did not find their way into the final statutory enactment.

- **Penalties, oh what penalties!** — New §§ 6662(b)(6), in conjunction with new § 6664(c)(2), imposes a *strict liability* 20 percent penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of new § 7701(o), “or failing to meet the requirements of any similar rule of law.” (Does that extend to substance versus form in a SILO? How about business purpose in a purported tax-free reorganization?) The penalty is increased to 40 percent if the taxpayer does not adequately disclose the relevant facts on the original return or an amended return filed before the taxpayer has been contacted for audit — an amended return filed after the initial contact cannot cure original sin. I.R.C. § 6664(i). Because the § 6664(c) “reasonable cause” exception is unavailable, outside (or in-house) analysis and opinions of counsel or other tax advisors will not insulate a taxpayer from the penalty if a transaction is found to lack economic substance. Likewise, new § 6664(d)(2) precludes a reasonable cause defense to imposition of the § 6662A reportable transaction understatement penalty for a transaction that lacks economic substance. (Section 6662A(e)(2) has been amended to provide that the § 6662A penalty with respect to a reportable transaction understatement does not apply to a transaction that lacks economic

substance if a 40 percent penalty is imposed under § 6662(i)). A similar no-fault penalty regime applies to excessive erroneous refund claims that are denied on the ground that the transaction on which the refund claim was based lacked economic substance. § 6676(c). However, under the “every dark cloud has a silver lining” maxim, the §§ 6662(b)(6) and 6664(c)(2) penalty regime does not apply to any portion of an underpayment on which the § 6663 fraud penalty is imposed.

- **Effective date** — Section 7701(o) and the revised penalty rules applies to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after 3/30/10.

- a. **Better than a sharp stick in the eye, but not much better. The IRS is catching conjunctivitis, weighing in on the conjunctive test.** Notice 2010-62, 2010-40 I.R.B. 411 (9/13/10). The IRS indicates that it will rely on relevant case law in applying the two-pronged conjunctive test for economic substance. Thus, both in determining whether a transactions meets both of the requirements of the conjunctive test, the IRS will apply cases under the common law economic substance doctrine to determine whether tax benefits are allowable because a transaction satisfies the economic substance prong of the economic substance doctrine and to determine whether a transaction has a sufficient nontax purpose to satisfy the requirement that the tax benefits of a transaction are not allowable because the taxpayer lacks a business purpose. The IRS adds that it will challenge taxpayers who seek to rely on case law that a transaction will be treated as having economic substance merely because it satisfies either of the tests. The IRS also indicates that it anticipates that the law of economic substance will continue to evolve and that it “does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”

- The Notice also indicates that, except for reportable transactions, disclosure for purposes of the additional penalty of § 6621(i) will be adequate if the taxpayer adequately discloses on a timely filed original return, or a qualified amended return the relevant facts affecting the tax treatment of the transaction. A disclosure that would be deemed adequate under § 6662(d)(2)(B) will be treated as adequate for purposes of § 6662(i). The disclosure should be made on a Form 8275 or 8275-R.

- b. **In the absence of helpful IRS guidance, LB&I steps up with something to lean on for the meanwhile. Taxpayers must be notified at the outset of the process.** LB&I-4-0711-015. Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (7/15/11). The Large Business and International Division of the IRS has issued guidance regarding the process that an examiner must follow in determining whether to seek approval of the Director of Field Operations (DFO) to apply the § 7701(o) economic substance doctrine. “An examiner should notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the analysis in the steps described below.” There are three steps in the analysis.

- **Three step analysis:** (1) First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. (2) Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate. (3) Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries before seeking approval to apply the doctrine.

- Facts and circumstances indicating that the economic substance doctrine should not be applied:

- (1) The transaction is not promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is not highly structured;
- (3) The transaction contains no unnecessary steps;
- (4) The transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives;

- (5) The transaction is at arm's length with unrelated third parties;
- (6) The transaction creates a meaningful economic change on a present value basis (pre-tax);
- (7) The taxpayer's potential for gain or loss is not artificially limited;
- (8) The transaction does not accelerate a loss or duplicate a deduction;
- (9) The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- (10) The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- (11) The transaction does not involve a tax-indifferent counter-party that recognizes substantial income;
- (12) The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (13) The transaction has credible business purpose apart from federal tax benefits;
- (14) The transaction has meaningful potential for profit apart from tax benefits;
- (15) The transaction has significant risk of loss;
- (16) Tax benefit is not artificially generated by the transaction;
- (17) The transaction is not pre-packaged.
- (18) The transaction is not outside the taxpayer's ordinary business operations.

• Facts and circumstances indicating that the economic substance doctrine **should be applied**:

- (1) The transaction is promoted/developed/administered by tax department or outside advisors;
- (2) The transaction is highly structured;
- (3) The transaction includes unnecessary steps;
- (4) The transaction is not at arm's length with unrelated third parties;
- (5) The transaction creates no meaningful economic change on a present value basis (pre-tax);
- (6) The taxpayer's potential for gain or loss is artificially limited;
- (7) The transaction accelerates a loss or duplicates a deduction;
- (8) The transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- (9) The taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- (10) The transaction involves a tax-indifferent counter-party that recognizes substantial income;
- (11) The transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- (12) The transaction has no credible business purpose apart from federal tax benefits;
- (13) The transaction has no meaningful potential for profit apart from tax benefits;
- (14) The transaction has no significant risk of loss;
- (15) Tax benefit is artificially generated by the transaction;
- (16) The transaction is pre-packaged;
- (17) The transaction is outside the taxpayer's ordinary business operations.

• The seven required subsequent inquiries:

(1) Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(2) Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(3) Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(4) Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(5) Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(6) Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(7) In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

- *Approval Process.* If an examiner completes the inquiries described above and concludes that it is appropriate to seek approval for the application of the economic substance doctrine, the examiner, in consultation with his or her manager and territory manager, should describe the analysis in writing for the appropriate Director of Field Operations, whose approval is required.

- *Penalties Limitation.* Until further guidance is issued, the penalties provided in §§ 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

- *Really!?* The final sentence of the directive reads as follows: "This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such."

c. **"I'm not sure how important it is to have formal guidance — this is what's supposed to be issued. It sets forth the procedures that exam, counsel, [and] managers need to follow . . . who's the formal guidance supposed to benefit?"** — Mark Silverman, 2011 TNT 137-1.

**C. Disclosure and Settlement**

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

1. **If it's "too good to be true," it ain't true.** *Gustashaw v. Commissioner*, T.C. Memo. 2011-195 (8/11/11). In a an opinion by Judge Halpern, the Tax Court upheld accuracy related penalties of over \$1,000,000 against an investor in a CARDS tax shelter, with respect to which the investor had an opinion from Brown & Wood. Judge Halpern concluded as follows:

A reasonable and ordinarily prudent person would have considered as "too good to be true" a carryover deduction generated from a previously claimed \$9,938,324 tax loss when he did not suffer an associated economic loss and invested only \$800,000 in the transaction. As such, he would have conducted a thorough investigation before claiming the deduction on his tax return. ...

[The taxpayer] did not attempt to understand the mechanics of the CARDS transaction, executed the transaction documents without reading them and without an attorney's review, and, although aware of the transaction's untested tax ramifications, declined to seek a ruling from the IRS. Further, he did not question the claimed carryover loss amount even though he knew that he did not suffer an associated economic loss.



• Furthermore, Judge Halpern held that the taxpayer's reliance of the Brown & Wood opinion was "unreasonable" because he should have known that Brown & Wood had an inherent conflict of interest; the promoter of CARDS both referred Brown & Wood to the taxpayer and supplied him with a model tax opinion letter describing a CARDS transaction that was not unique to the taxpayer's situation. There was no evidence that the taxpayer had an engagement letter with Brown & Wood, spoke to any attorney at the law firm, or directly compensated Brown & Wood for a tax opinion letter. The taxpayer "could not have reasonably believed that Brown & Wood was an independent adviser."

2. **Tax professionals compensated at hourly rates were "independent advisers," but § 6662 penalties were nevertheless imposed because the Son of BOSS transaction was "too good to be true."** Candyce Martin 1999 Irrevocable Trust v. United States, 2011 U.S. Dist. LEXIS 115616 (N.D. Cal. 10/8/11). Trusts for the San Francisco Chronicle heirs and the heirs themselves entered into digital options Son of BOSS transactions to shield more than \$300 million of capital gain from taxation arising from the sale of their stock in Chronicle Publishing Company in 2000. Judge Hamilton held that the transactions failed for federal income tax purposes because (1) the obligations on the short options constituted liabilities for purposes of § 752; (2) the transactions lacked economic substance; and (3) the transactions were not entered into profit so losses were nondeductible under § 165.

• The trustee of the trusts [Peter Folger] and the leading Martin family member [Francis Martin] engaged San Francisco tax lawyer Richard Sideman – a Harvard Law School graduate, with a Masters in Tax from NYU, who had previously advised the family on gift tax and trust reformation issues – to advise the trusts and heirs as to the tax and non-tax consequences of their Chronicle Publishing stock sale. Sideman did a great deal of investigation by getting advice from large accounting firms, investment banks, economists, and R.J. Ruble, which resulted in proposed transactions and proposed opinion letters undergoing numerous changes. Finally, the transactions proposed by JP Morgan and implemented by PWC, with R.J. Ruble opinion letters were decided upon; Sideman "greenlight[ed]," i.e., approved, the transactions. In upholding § 6662 penalties and denying taxpayers' "reasonable cause and good faith defense," Judge Hamilton stated:

In challenging the negligence and substantial authority penalties, petitioners contend that they demonstrated reasonable cause and good faith as an absolute defense to those accuracy-related penalties. Section 6664(c) provides that "[n]o penalty shall be imposed under section 6662 . . . if it is shown [1] that there was a reasonable cause for [the underpayment] and [2] that the taxpayer acted in good faith." 26 U.S.C. § 6664(c)(1). The reasonable-cause-and-good-faith defense acknowledges that penalties are inappropriate when a taxpayer underpays as a result of "an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances." Treas. Reg. § 1.6664-4(b)(1). The taxpayer carries the burden of establishing the reasonable cause and good faith exception. See 26 U.S.C. § 6662, 6664(c). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

Petitioners contend that they had reasonable cause and acted in good faith because they reasonably relied on the advice of competent and independent professional advisors. Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1). However, mere reliance on the advice of a professional tax advisor "does not necessarily demonstrate reasonable cause and good faith." *Id.* A taxpayer's claim of reliance upon professional advice as support for this defense is to be evaluated under an objective standard. "The reasonableness of any reliance turns on the quality and objectivity of the advice." *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1381 (Fed. Cir. 2010). Reasonable cause requires the taxpayer to show that

the advice was based on "all pertinent facts and circumstances and the law as it relates to those facts and circumstances." Treas. Reg. § 1.6664-4(c)(1)(i).

At trial, Mr. Folger and the Martin family members testified that they did not have the expertise to fully understand how the transaction was structured and the tax ramifications and that they relied on the advice of the Sideman firm and PWC, primarily on Mr. Sideman. The evidence presented at trial tends to show that they relied on their tax attorney, Mr. Sideman, to review all the advisory opinions and analyses and to make a recommendation as to whether they should engage in the transaction. The evidence also demonstrates that Mr. Folger and the Martin family had negligible contact with either Dr. Rubinstein or Mr. Ruble, on whom Mr. Sideman relied for an analysis of the business purpose and legality of the transaction. Mr. Folger testified that he did not understand the Ruble opinion letter and relied on Mr. Sideman "to say this was an authentic, valid transaction, and I satisfied myself that he was answering that question." Tr. 267:3-23. While the record is clear that Mr. Folger and the Martin family relied heavily on Mr. Sideman, the record is not clear as to the extent that they relied directly on the advice of Dr. Rubinstein and Mr. Ruble, if at all. It was Mr. Sideman who appears to have relied on the advice of Dr. Rubinstein and Mr. Ruble in advising Mr. Folger and the Martin family.

With regard to Dr. Rubinstein's economic advice, the record establishes that he was given a very limited set of facts on which to conduct his analysis of whether the transaction could have a business purpose. As he testified at trial, Dr. Rubinstein limited his analysis to whether the offsetting options portfolios could make a profit but did not take into account the preexisting holdings of cash which were converted to SPDRs. Dr. Rubinstein did not know that petitioners started in a position of cash and was also instructed not to consider any tax consequences of the transaction [*sic*]. Thus, any reliance on Dr. Rubinstein's advice would not be reasonable because his conclusions were not based on all pertinent facts and circumstances as required for reasonable cause. \*\*\*

For his part, Mr. Sideman understood that Mr. Folger and the Martin family relied on him to "greenlight" or approve the transaction, but denied that he designed the transaction with PWC and JP Morgan. Tr. 149:10-20; 250:17-25. Mr. Sideman communicated primarily with Mr. Martin as the principal voice on behalf of the Martin family. Tr. 134:16-25. Mr. Sideman testified that he saw his role as that of overseeing the transaction "in a broad way [and] hiring or engaging at my recommendation the most qualified people that I knew who could provide the actual expertise about the transaction and about its financial implications." Tr. 152:19-25. Mr. Sideman characterized himself as a tax controversy lawyer, unfamiliar with economic judgments involving financial matters to advise the Martin family directly on the issue whether the tax proposal by Arthur Andersen, and the subsequent proposal by PWC, would have an economic reality or economic benefit. Mr. Sideman testified that he relied on the advice of PWC, Dr. Rubinstein and Mr. Ruble to examine the business purpose of the proposed transaction. Tr. 143:4-145:16.

While the evidence at trial establishes that Mr. Folger and the Martin family relied on Mr. Sideman's advice, the trial evidence lacks clarity as to exactly what advice Mr. Sideman gave them, other than approving or "greenlighting" the transaction based on the advice he received from the other professionals. The weaknesses noted above in the Ruble and Rubinstein opinions, as well as other aspects of the transaction, should have put at least Mr. Sideman, if not the taxpayers, on notice that the transaction was a questionable tax avoidance scheme lacking economic substance. However, the question before the court is not whether Mr. Sideman's reliance on professional advice was reasonable, but

whether Mr. Folger and the Martin family's reliance on Mr. Sideman's and the other professionals' advice was reasonable. As previously noted, it is not clear to what extent the taxpayers themselves relied on any advice other than Mr. Sideman's. Nor was it established that Mr. Sideman ever specifically advised them that the transaction was bona fide or legal. All the evidence clearly establishes is that Mr. Sideman approved the transaction.

- Judge Hamilton rejected government contentions that taxpayers could not rely on PWC and Sideman because they had an inherent conflict of interest, stating that advisers compensated at an hourly rate were not conflicted:

The government contends that Mr. Folger's and the Martin family's reliance on the Sideman firm and PWC was unreasonable on the ground that those firms had an inherent conflict of interest arising from their roles in promoting and implementing the transaction and receiving fees. The court is satisfied, however, that the Sideman firm and PWC did not have a profit motive or other monetary interest in the outcome of the transaction because those advisors were paid at an hourly rate to advise Mr. Folger and the Martin family, regardless of whether they ultimately engaged in the transaction. There was not, in the court's view, a conflict of interest.

- However, the court found that taxpayers did not rely reasonably on Sideman's advice, concluding:

The government has not provided a clear argument or any authority for whether Mr. Sideman's unreasonable reliance on the professionals he hired should be imputed to the taxpayers. This was a highly sophisticated transaction, one for which a taxpayer would reasonably be expected to hire a tax lawyer. The court is not prepared to find that having retained a tax lawyer who "greenlights" a complicated transaction as having a business purpose, a taxpayer necessarily acts unreasonably by relying on that advice. See *United States v. Boyle*, 469 U.S. 241, 250-51, 105 S. Ct. 687, 83 L. Ed. 2d 622 (1985) (when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice, "even when such advice turned out to have been mistaken"). Even assuming, however, that the taxpayers acted reasonably in relying on their tax lawyer's advice to proceed with the transaction, to be entitled to the reasonable cause and good faith defense, the taxpayers must also prove that they acted in good faith. Good faith is not synonymous with objective reasonableness. Even if the concept of business purpose was too complicated for the taxpayers to assess and apprehend, the court finds that Mr. Folger and the Martin family have not demonstrated good faith under the circumstances and in light of the underlying purposes of entering into the transaction.

First, Mr. Folger and the Martin family should have known that the transaction resulting in a \$315.7 million tax basis for a \$0.9 million offsetting options transaction was "too good to be true." *Stobie Creek*, 608 F.3d at 1383. Furthermore, they knew that the purpose of the transaction was to boost the basis to generate a large capital loss to offset the capital gains from the CPC sale. Finally, they proceeded with the transaction even after the issuance of Notice 2000-44, entitled "Tax Avoidance Using Artificially High Basis," which alerted them that the basis created by the options transaction would likely be disallowed. Although they were advised by Mr. Sideman that the transaction had a legitimate business purpose, Mr. Folger and the Martin family entered into this transaction with the knowledge that it would generate an artificially high capital loss. Given the level of education and business experience shared by Mr. Folger and the Martin family, they should have known that the absence of a tax liability on a

sizeable capital gain did not reflect the economic reality of the transaction. The underpayment of tax was not, therefore, the result of “an honest misunderstanding of fact or law.” Treas. Reg. § 1.6664-4(b)(1). Because Mr. Folger, with the consent of the Martin family, did not act in good faith, the court finds that the accuracy-related penalty was appropriately applied here.

## **IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING**

### **A. Exempt Organizations**

1. **An agency’s interpretation of its regulation is controlling unless the interpretation is “plainly erroneous or inconsistent with the regulation.”** Polm Family Foundation v. United States, 107 A.F.T.R.2d 2011-2100 (D.C. Cir. 5/6/11). The issue in this declaratory judgment case was whether the Polm Family Foundation was a private foundation under § 509 or a § 509(a)(3)(II) supporting organization, treated as a public charity, the IRS having conceded that it was a § 501(c)(3) organization. Among the requirements to qualify under § 509(a)(3)(II) is that organization demonstrate that it is “organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [publicly supported] organizations.” The Foundation’s articles of incorporation designated as supported organizations “the class of organizations ... which support, promote and/ or perform public health and/or Christian objectives, including but not limited to Christian evangelism, edification and stewardship.” Reg. § 1.509(a)-4(d)(2)(i)(b) does not require a specific listing of the name each publicly supported organization, Reg. § 1.509(a)-4(d)(3) indicates that the articles of incorporation must require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose. The IRS argued that the exception to specific designation applies only if the class of beneficiary organizations is “readily identifiable,” and the court accepted the IRS’s argument that the class of beneficiary organizations was not “readily identifiable,” citing examples in Reg. § 1.509(a)-4(d)(2)(iii) (“institutions of higher learning in the State of Y”) and Rev. Rul. 81-43, 1981-1 C.B. 350 (“[tax-exempt public charities] located in the [city of] Z area”). The court found that “unlike the examples contained in the regulation and the revenue ruling, [the Foundation’s] designation does not make its beneficiary organizations readily identifiable. There is no geographic limit. There is no limit by type of publicly supported organization (such as churches or seminaries). In light of the broad purposes mentioned in Foundation’s articles of incorporation, we agree with the government that it would be difficult, if not impossible, to determine whether the Foundation will receive oversight from a readily identifiable class of publicly supported organizations.”

• Very significantly, in its analysis, the court stated as follows:

An agency’s interpretation of its regulation is controlling unless the interpretation is “plainly erroneous or inconsistent with the regulation.” *Auer v. Robbins*, 519 U.S. 452, 461 (1997). This is so even if the interpretation appears for the first time in a legal brief. *Chase Bank USA, N.A. v. McCoy*, 131 S. Ct. 871, 880–81 (2011); *Bigelow v. Dep’t of Def.*, 217 F.3d 875, 878 (D.C. Cir. 2000). “Because the interpretation the [IRS] presents in its brief is consistent with the regulatory text,” *Chase Bank*, 131 S. Ct at 880, we have no basis for rejecting it in favor of some other version.

2. **Your client put it off in for three years, so why not put it off until year-end 2012: Organizations which lost their tax-exempt status may seek reinstatement until 12/31/12.** IR-2011-63 (6/8/11). This information release provides guidance to help reinstate currently-existing organizations among the 275,000 which lost their tax-exempt status for failure to file required annual reports for three consecutive years. Notice 2011-43, 2011-25 I.R.B. 882; Notice 2011-44, 2011-25 I.R.B. 883; and Rev. Proc. 2011-36, 2011-25 I.R.B. 915, provide full details.

### **B. Charitable Giving**

1. **A “gotcha” for the IRS! The Tax Court just says “no” to deductions for contributions of conservation easements on mortgaged properties.** Kaufman v. Commissioner, 134 T.C. 182 (4/26/10). The Tax Court (Judge Halpern) held that as a matter of

law no charitable contribution deduction is allowable for the conveyance of an otherwise qualifying conveyance of a facade conservation easement if the property is subject to a mortgage and the mortgagee has a prior claim to condemnation and insurance proceeds. Because the mortgage has priority over the easement, the easement is not protected in perpetuity – which is required by § 170(h)(5)(A). The deduction cannot be salvaged by proof that the taxpayer likely would satisfy the debt secured by the mortgage.

a. **Plea for a Mulligan is rejected! Kaufman v. Commissioner, 136 T.C. No. 13 (4/4/11).** On the taxpayers' motion for reconsideration, the Tax Court (Judge Halpern) in a lengthy and thorough opinion reaffirmed its earlier decision that the conservation easement failed the perpetuity requirement in Reg. § 1.170A-14(g)(6), because under the loan documents, the bank that held the mortgage on the property expressly retained a “‘prior claim’ to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property and all proceeds of condemnation,” and agreement also provided that “the bank was entitled to those proceeds ‘in preference’ to [the donee organization] until the mortgage was satisfied and discharged.” The court also disallowed a deduction in 2003, but allowed the deduction in 2004, for a cash contribution to the donee of the conservation easement in 2003 because the amount of the cash payment was subject to refund if the appraised value of the easement was zero, and the appraisal was not determined until 2004. The court also rejected the IRS's argument that the taxpayer received a *quid pro quo* for the cash contribution in the form of the donee organization accepting and processing their application, providing them with a form preservation restriction agreement, undertaking to obtain approvals from the necessary government authorities, securing the lender agreement from the bank, giving the taxpayers basic tax advice, and providing them with a list of approved appraisers. The facts in evidence did not demonstrate a *quid pro quo*, because, among other things, many of the tasks had been undertaken by the organization before the check was received.

- Finally, the court declined to uphold the § 6662 accuracy related penalties asserted by the IRS for the taxpayer's overstatement of the amount of the contribution for the conservation easement, but sustained the negligence penalty for the 2003 deduction for the cash payment. Because the issue of whether any deduction was allowed for the easement, regardless of its value, was a matter of law decided in the case as a matter of first impression, the taxpayers were not negligent, had reasonable cause, and acted in good faith.

b. **Another facade conservation easement deduction on mortgaged property bites the dust, with an alternative ground of uselessness. 1982 East, LLC v. Commissioner, T.C. Memo. 2011-84 (4/12/11).** *Kaufman* was followed to deny the claimed charitable contribution deduction for a facade conservation easement burdening mortgaged property where the lender had a “‘prior claim’” to all condemnation and insurance proceeds “‘in preference’ to [the donee] ‘until’ that mortgage was satisfied and discharged. ... [A]t any point before the mortgage was repaid, the possibility existed for [the lender] First Republic Bank to deprive [the donee] of value that should have otherwise been dedicated to the conservation purpose.”

- **Alternatively**, the deduction was disallowed because the building with respect to which the easement was granted was in the New York City Metropolitan Museum Historic District, and local law protected the building against alteration and the easement provided no additional protection.

2. **A possibly faulty conservation easement deduction saved by local preservation laws. Simmons v. Commissioner, T.C. Memo. 2009-208 (9/15/09).** Judge Wherry held that facade conservation easements validly supported a charitable contribution deduction, even though they allowed the easement holder to consent to changes to the properties, because any rehabilitative work or new construction on the facades was required to comply with the requirements of all applicable Federal, State, and local government laws and regulations. Reg. § 1.170A-14(d)(5) allows a donation to satisfy the conservation purpose's test even if future development is allowed, as long as that future development is subject to local, State, and Federal laws and regulations. That the properties were already subject to local preservation laws did not prevent any charitable contribution deductions, because even though the easements were

duplicative in some respects, the easements subjected the taxpayer to a higher level of enforcement than that provided by local law.

a. **Affirmed.** 107 A.F.T.R.2d 2011-2632 (D.C. Cir. 6/21/11). The Court of Appeals (Judge Ginsburg) agreed with the Tax Court that even though the deeds did not spell out precisely what would happen upon the dissolution of the donee, District of Columbia law provides the easements would be transferred to another organization that engaged in “activities substantially similar to those of” the grantee. The court reasoned that the clauses permitting changes or abandonment upon the donee’s consent had “no discrete effect upon the perpetuity of the easements” because “[a]ny donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril.” The deduction could not be disallowed based upon the remote possibility the donee would abandon the easements. Finally, the court rejected the government’s argument that the deduction should be disallowed because the taxpayer did not obtain qualified appraisals meeting the requirements of Reg. § 1.170A-13(c)(3)(ii) the Tax Court did not clearly err in concluding the appraisals sufficiently identified the method and basis for the valuations.

3. **Both their house and their claimed charitable contribution deduction went up in smoke. District Court denies deduction for about-to-be-demolished house to local fire department on “qualified appraisal” and “contemporaneous written acknowledgment” grounds, but ducks the issue of whether taxpayers could claim a deduction for this type of donation. Hendrix v. United States, 106 A.F.T.R.2d 2010-5373 (S.D. Ohio 7/21/10).** When the taxpayers found it would cost \$10,000 to demolish their house so they could build a new house on the land, in 2004 they entered into a transaction under which the local fire department could use their house for training and return the cleared land to the taxpayers. They claimed a charitable contribution deduction of \$287,400 – based upon an appraisal of \$520,000 for the property. The District Court (Judge Frost) denied the deduction on failure to obtain a “qualified appraisal” as required by § 170(f)(11)(A) and failure to obtain a “contemporaneous written acknowledgment” as required by § 170(f)(8). While Judge Frost did not answer the question of whether “taxpayers may be able to claim a deduction for the type of donation involved in this case” if a qualified appraisal and written acknowledgment had been obtained, he did include in his opinion that Deloitte & Touche had advised the taxpayers that “[d]onation of property to a fire department is aggressive and not explicitly sanctioned by the Internal Revenue Code.”

a. **Now the Tax Court holds that the gambit does not work at all. Rolfs v. Commissioner, 135 T.C. 471 (11/4/10), on appeal to the Seventh Circuit.** The taxpayers donated a home, but not the underlying land, to the local volunteer fire department to be burned down in a training exercise. The fire department could not use the house for any purpose other than destruction by fire in training exercises. The taxpayers claimed a charitable contribution deduction of \$76,000 based on a “before and after” valuation, comparing the value of the parcel with the building intact and the value of the parcel after demolition of the building; they complied with all record keeping and substantiation requirements. The Tax Court (Judge Gale) upheld the IRS’s denial of the deduction. First, based on expert testimony, he found that the taxpayers received a quid-pro-quo in the amount of \$10,000, which was the value of the demolition services provided to them by the donee fire department. Second, he found that the building, with ownership severed from the land and burdened by the condition that it be removed, i.e., in this case demolished, had no value. The lack of value was established by the expert testimony of home movers, who testified that considering the costs of removal to another site, the modest nature of the home, and the value of nearby land, no one would purchase the home for more than a nominal amount, between \$100 and \$1,000, sufficient to render the contract enforceable. Judge Gale held that because the consideration received by the taxpayers exceeded the value of the transferred property, there was no charitable contribution. He rejected application of the “before and after” valuation method, because that method did not take into account the restrictions that would have affected the marketability of the structure severed from the land.

4. **“Praise the Lord, [but] pass the ammunition.” Or, is it that the judge was hypertechnical?** Lord v. Commissioner, T.C. Memo. 2010-196 (9/8/10). Charitable contribution deduction for a conservation easement was denied because the appraisal in the amount of \$242,000 submitted to comply with Reg. 1.170A-13(c)(2)(i)(A) was not a “qualified appraisal.” The Tax Court (Judge Foley) held that this was because the appraisal itself did not include: (1) the easement contribution date; (2) the date the appraisal was performed; or (3) the appraised fair market value of the easement contribution on the contribution date. Judge Foley further held that the doctrine of substantial compliance was not applicable because significant information was omitted from the appraisal.

- The background facts were that taxpayer granted a deed of conservation easement to the Land Preservation Trust on 12/30/99; that the Paige Appraisal Company produced an appraisal report [stating the fair market value of the easement] with an effective date of 12/31/99; and that the report date was 1/4/00.

a. **Retrospective “as of” appraisals don’t cut the mustard.** Evans v. Commissioner, T.C. Memo. 2010-207 (9/22/10). Judge Wherry disallowed the taxpayers’ deduction for the contribution of a conservation facade easement due to inadequate substantiation. The appraisal introduced at trial was not a qualified appraisal because it was prepared almost four years after the date of the donation, and the appraiser testified that she was unfamiliar with the standards for a qualified appraisal. Qualified appraisals by qualified appraisers, upon which taxpayer relied in preparing the return were not introduced into evidence because the appraisers did not testify at trial. However, an asserted § 6662 accuracy related penalty was not sustained because in preparing the return the taxpayer reasonably relied on qualified appraisals by the qualified appraisers.

5. **“Too good to be true” turns out not to be true at all.** Gundanna v. Commissioner, 136 T.C. No. 8 (2/14/11). In 1998, the taxpayer transferred over \$250,000 of appreciated stock to the xélan Foundation, a § 501(c) (3) organization that was not a private foundation. The stock was held “as ‘a donor advised fund’ or ‘family public charity’ (Foundation account), by means of which a donor’s donations would be segregated for investment and future distribution as the donor might recommend.” The taxpayer claimed a charitable contribution deduction; he did not include in income any gain from the sales of the stocks that had been transferred to the Foundation and which Foundation had sold in 1998, or any dividends or interest generated by the assets in petitioner’s Foundation account. Pursuant to the taxpayer’s requests, the Foundation made distributions from his Foundation account of several thousand dollars to the Shiva Vishnu Temple in each of the years 1999 through 2002. In addition, in 2001 and 2002, at the taxpayer’s request, \$70,299 was distributed from his Foundation account to the University of Pennsylvania in connection with the Foundation’s student loan program, as a loan to the taxpayer’s son to cover the cost of his tuition, room, and board. In 2003, approximately \$19,500 was distributed to the taxpayer to pay his legal fees in connection with an audit that proposed disallowance of the charitable contribution deduction claimed for 1998. During the course of the audit, the taxpayer repaid the principal of his son’s student loans, but the Foundation waived accrued interest. The Tax Court (Judge Gale) upheld the IRS’s disallowance of the charitable contribution deduction on the ground that the taxpayer retained dominion and control over the property transferred to the Foundation and held in his Foundation account. This conclusion was based “principally on the basis of the use of funds in petitioner’s Foundation account for student loans to his son.” The taxpayer’s “understanding, at the time he transferred the stocks to his Foundation account in 1998, that the account’s assets could be used to make student loans to his children, and the Foundation’s perfunctory acquiescence in making such loans in subsequent years, provide substantial support for the conclusion that petitioner neither intended, nor in fact did, cede dominion and control over the property transferred to the Foundation in 1998.” Judge Gale also found “that the promotion of another Foundation account feature – petitioner’s ability to arrange for distributions of account funds to compensate himself or family members for performance of ‘good works’ – also support[ed] the conclusion that petitioner maintained control of the assets in his Foundation account.” Alternatively, Judge Gale held that the substantiation requirements of § 170(f)(8)(A) had not been satisfied because,

despite the Foundation providing the taxpayer with a contemporaneous written acknowledgment stating that no goods or services had been provided, under Reg. § 1.170A-13(f)(6) goods or services that the taxpayer expects to receive in the future must be taken into account, and when the taxpayer transferred the stock to the Foundation he expected to receive goods or services in the form of student loans to his children. In addition to upholding disallowance of the charitable contribution deduction, Judge Gale held that because the taxpayer retained dominion and control over the funds, he was taxable on the capital gains and other income earned by the fund. Finally, and not surprisingly, § 6662 accuracy related penalties for negligence and substantial underpayment were upheld.

[P]etitioners were negligent because petitioner failed to make a reasonable attempt to ascertain the correctness of a deduction which would seem to a reasonable or prudent person to be “too good to be true” under the circumstances. A reasonable or prudent person would have perceived as “too good to be true” a deduction for a supposed charitable contribution where the amounts deducted could be used to fund student loans for his own children.

- Judge Gale rejected the taxpayer’s argument that the taxpayer because the Foundation was listed in Publication 78, he had substantial authority for the deduction.

6. **Another claimed conservation easement sinks in quicksand.** Boltar, L.L.C. v. Commissioner, 136 T.C. No. 14 (4/5/11). In a conservation easement charitable contribution deduction case, the Tax Court (Judge Cohen), sustained the IRS’s motion to exclude the taxpayer’s expert’s valuation report because it the taxpayer’s expert failed to apply the correct standards required by Reg. § 1.170A-14(h)(3)(i). He did not determine the value of the donated easement by the “before and after” valuation method, did not value contiguous parcels owned by the taxpayer and encumbered by conservation easements, and assumed development potential (for a 174 unit condominium) that actually was not feasible on the property. As a result, the deduction was disallowed and the deficiency upheld.

7. **The boilerplate can kill ya!** Schrimsher v. Commissioner, T.C. Memo. 2011-71 (3/28/11). The taxpayers granted a facade easement with respect to property in Huntsville, Alabama, commonly known as the “Times Building,” to the Alabama Historical Commission. They claimed a charitable contribution deduction, listing on the Form 8283 the appraised fair market value of the facade easement as \$705,000. The “Appraisal Summary” on the Form 8283 omitted various items of required information, and it was not signed or dated by the donor, the appraiser, or any representative of the donee; a written appraisal of the facade easement was not attached. The agreement facade easement stated:

[F]or and in consideration of the sum of TEN DOLLARS, plus other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Grantor [taxpayer] does hereby irrevocably GRANT, BARGAIN, SELL, AND CONVEY unto the Grantee [the commission], its successors and assigns, a preservation and conservation easement to have and hold in perpetuity ... .

- The agreement also provided as follows: “This agreement sets forth the entire agreement of the parties with respect to the Easement and supercedes all prior discussions, negotiations, understanding, or agreements relating to the Easement, all of which are merged herein.” The Tax Court (Judge Thornton) granted summary judgment upholding the disallowance of the deduction because there was no other written acknowledgment of the gift, the agreement failed the requirements of § 170(f)(8)(B)(iii) because it did not include a description and good faith estimate of the “other good and valuable consideration.”

8. **A touch of *Cohan* [?], with a cap, for the Cat Woman’s unreimbursed charitable volunteer expenses.** Van Dusen v. Commissioner, 136 T.C. No. 25 (6/2/11). The taxpayer claimed charitable contribution deductions for out-of-pocket expenses incurred in caring for “foster cats” as a volunteer on behalf of Fix Our Ferals, a § 501(c)(3) organization. The Tax Court (Judge Morrison) applied the “substantial compliance doctrine” to allow a deduction for expenses incurred by a volunteer providing services to a charitable organization,



even though the taxpayer's records did not strictly meet the specific requirements of Reg. § 170A-13(a)(1). The taxpayer's documents were "legitimate substitutes for canceled checks," because they contained all of the information that would have been on a canceled check — the name of the payee, the date of the payment, and the amount of the payment. Although the regulation requiring substitute records to reflect the name of the donee was not written with unreimbursed volunteer expenses in mind. However, because the amounts expended exceeded \$250 and the taxpayer failed to satisfy requirements of § 170(f)(8)(a) and Reg. § 1.170A-13(f)(1) for substantiation in the form of a contemporaneous written acknowledgment from the charitable organization, the deductible amount for each separate expenditure was limited to \$250.

- Query whether prudent planning in the future should be: "If it flies or floats, don't own – rent; if it barks or meows, don't adopt – foster."

9. **How can the Tax Court deny a charitable donation deduction to a taxpayer named "DiDonato"?** DiDonato v. Commissioner, T.C. Memo. 2011-153 (6/29/11). The Tax Court (Judge Laro) denied a 2004 charitable contribution deduction on grounds of lack of substantiation under § 170(f)(8). The alleged donation was memorialized by a 2004 contract between taxpayer and the charitable recipient but the formal transfer did not occur until 2006, when the donation was acknowledged. The 2006 acknowledgment was too late to substantiate a 2004 deduction because it was received by taxpayer after his 2004 federal income tax return was filed.

## X. TAX PROCEDURE

### A. Interest, Penalties and Prosecutions

1. **The instructions for the new FBAR are FUBAR.** IR-2009-58 and Announcement 2009-51, 2009-25 I.R.B. 1105 (6/5/09). The IRS announced that for the Reports of Foreign Bank and Financial Accounts (FBARs) due on 6/30/09, filers of Form TD F 90-22.1 (Rev. 10-2008) need not comply with the new instruction relating to the definition of a United States Person, *i.e.*:

**United States Person.** The term "United States person" means a citizen or resident of the United States, or a person in and doing business in the United States. See 31 C.F.R. 103.11(z) for a complete definition of 'person.' The United States includes the states, territories and possessions of the United States. See the definition of United States at 31 C.F.R. 103.11(nn) for a complete definition of United States. A foreign subsidiary of a United States person is not required to file this report, although its United States parent corporation may be required to do so. A branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.

- Instead, for this year, taxpayers and others can rely on the definition of a United States person included in the instruction to the prior form (7-2000):

**United States Person.** The term "United States person" means: (1) a citizen or resident of the United States; (2) a domestic partnership; (3) a domestic corporation; or (4) a domestic estate or trust.

a. Notice 2009-62, 2009-35 I.R.B. 260 (8/7/09). By this notice, the IRS extended the filing deadline until 6/30/10 to report foreign financial accounts on Form TD F 90-22.1 for persons with signature authority over (but no financial interest in) a foreign financial account and persons with signature authority over, or financial interests in, a foreign commingled fund.

b. **Still clear as mud: New definitions and instructions.** RIN 1506-AB08, Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, 75 F.R. 8844 (2/26/10). This proposed rule would include a definition of "United States person" and definitions of "bank account," "securities account," and "other financial account," as well as of "foreign country." It also includes draft instructions to Form TD F 90-22.1 (FBAR).

(1) Notice 2010-23, 2010-11 I.R.B. 441 (2/26/10). Provided administrative relief to certain person who may be required to file and FBAR for the 2009 and

earlier calendar years by extending the filing deadline until 6/30/11 for persons with signature authority, but no financial interest in, a foreign financial account for which an FBAR would have otherwise been due on 6/30/10. It also provides relief with respect to mutual funds.

(2) Announcement 2010-16, 2010-11 I.R.B. 450 (2/26/10). The IRS suspended, for person who are not U.S. citizens, U.S. residents, or domestic entities, the requirement to file an FBAR for the 2009 and earlier calendar years.

c. **Second (or, is it the third?) special voluntary disclosure initiative available through 8/31/11.** IR-2011-14 (2/8/11). The 2011 Offshore Voluntary Disclosure Initiative is similar to the 2009 Offshore Voluntary Disclosure Program with a 25-percent penalty and an 8-year look-back requirement (both slightly-increased from 2009). There are lower penalties in some limited situations (5 percent) and where offshore accounts do not surpass \$75,000 (12.5 percent). All original and amended tax returns must be filed and payment of all taxes, interest and penalties must be made by the 8/31/11 deadline.

• Subsequent Q&As offer the possibility of a 90-day extension to complete the voluntary disclosure where total compliance had not been made by the deadline despite good faith attempts. See Q&A 25.1.

d. **Additional relief for persons with signature authority.** Notice 2011-54, 2011-29 I.R.B. \_\_\_ (6/16/11). Provides additional relief to persons whose requirement to file Form TD-F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), for calendar year 2009 or earlier calendar years was based solely upon signature authority. Their deadline is now 11/1/11. The deadline for reporting signature authority over, or a financial interest in, foreign financial accounts for the 2010 calendar year remains 6/30/11.

• Reporting problems occur for former employees, as well as with respect to foreign accounts that give signature authority to “all officers.”

2. **The “TurboTax got it wrong for me just like Wikipedia says it did for Timothy Geithner” defense doesn’t cut the mustard.** Lam v. Commissioner, T.C. Memo. 2010-82 (4/19/10). Based on a stipulation, the Tax Court (Judge Wherry) upheld a deficiency determined by the IRS based on the application of § 280A to disallow claimed rental real estate losses and recharacterization of claimed ordinary losses as capital losses. The court also upheld accuracy related penalties, finding that there was no substantial authority for the taxpayer’s positions and that the reasonable cause exception did not apply. The taxpayers argued that they consistently filled out their tax returns using TurboTax and that they confused capital gains and losses with ordinary income and expenses. Even though Judge Wherry believed that the errors were made in good faith, he held that they did not behave in a manner consistent with that of a prudent person. They did not consult a tax professional or visit the IRS’s web site for instructions on filing the Schedule C. He did not accept their misuse of TurboTax, even if unintentional or accidental, as a defense to the penalties, because they did not attempt to show a reasonable cause for their underpayment of taxes. Rather, they analogized their situation to that of the Secretary of the Treasury, Timothy Geithner.

Citing a Wikipedia article, Ms. Lam essentially argues that, like Secretary Geithner, she used TurboTax, resulting in mistakes on her taxes. In short, it was not a flaw in the TurboTax software which caused petitioners’ tax deficiencies. “Tax preparation software is only as good as the information one inputs into it.” [citation omitted]. Because petitioners have not “shown that any of the conceded issues were anything but the result of [their] own negligence or disregard of regulations,” they are liable for the section 6662(a) penalties.

a. **Another case on TurboTax. The case does not reflect whether the IRS was ashamed, but it was undeterred in seeking penalties for conduct unpenalized with respect to the Secretary of Treasury.** Parker v. Commissioner, T.C. Summ. Op. 2010-78 (6/21/10). The Tax Court (Judge Chiechi) held that taxpayer’s compensation from the International Monetary Fund was subject to self-employment taxes. Accuracy-related penalties were imposed despite taxpayer’s argument that he relied on his tax return preparation software.

b. **Ouch! The Tax Court again rejected taxpayers' use of the "Geithner defense" and held that blaming H&R Block tax preparation software for errors on their return did not excuse them from penalties.** Au v. Commissioner, T.C. Memo. 2010-247 (11/10/10). In this pro se case, the court (Judge Cohen) upheld the imposition of the accuracy related penalty on taxpayers who deducted gambling losses in the absence of any gambling winnings, stating:

Petitioners contend that they followed the instructions on the [H&R Block Tax Cut] tax preparation software that they used in preparing their 2006 tax return, asserting that the software was "approved by the IRS." They indicate that they were unaware of the provisions of the Code and that they did not consult any Internal Revenue Service (IRS) publications or professional tax advisers before claiming deductions equaling almost half of their reported income in 2006. The software instructions are not in the record, so we cannot determine how the error occurred. We doubt that the instructions, if correctly followed, permitted a result contrary to the express language of the Code. Petitioners may have acted in good faith but made a mistake. In the absence of evidence of a mistake in the instructions or a more thorough effort by petitioners to determine their correct tax liability, we cannot conclude that they have shown reasonable cause for the underpayment of tax on their 2006 return.

3. **Let the sunshine in.** Rev. Proc. 2011-13, 2011-3 I.R.B. 318 (12/29/10). This revenue procedure identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d) (relating to the substantial understatement accuracy-related penalty) and for the purpose of avoiding the tax return preparer penalty under § 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns for any income tax return filed on a 2010 tax form for a taxable year beginning in 2010, and to any income tax return filed on a 2010 tax form in 2011 for a short taxable year beginning in 2011. It does not apply with respect to any other penalty provisions (including the disregard provisions of the § 6662(b)(1) accuracy-related penalty, the § 6662(i) increased accuracy-related penalty for undisclosed noneconomic substance transactions, and the § 6662(j) increased accuracy-related penalty in the case of undisclosed foreign financial asset understatements).

4. **Literal compliance with the tax laws in a transaction that lacks economic substance results in a valid indictment of a tax advisor.** United States v. Daugerdas, 106 A.F.T.R.2d 2010-7432 (12/23/10 S.D. N.Y.). The district court (Judge Pauley) denied the defendants' motion to dismiss over twenty counts of an indictment for aiding and abetting tax evasion in connection with the design, marketing, and implementation of four tax shelters: the Short Sale, Short Options Strategy ("SOS"), Swaps, and HOMER tax shelters. All of the shelters were based on the Tax Court's decision in *Helmer v. Commissioner*, T.C. Memo. 75-160. The defendant's argued that the indictment failed to allege willfulness for three reasons: "(1) a transaction's economic effect is measured by whether it subjects the taxpayer to market risk, not whether it provides a realistic possibility of profit; (2) even if the possibility-of-profit test is proper, there was no known legal duty to account for fees when measuring a transaction's profit potential; and (3) *Helmer*-based tax strategies were not outlawed by the IRS until after Defendants executed the transactions at issue." The court rejected all three arguments. As to the first argument, the court concluded, "Defendants mistakenly assert that the economic effect component of the economic substance doctrine asks only whether a transaction subjects the taxpayer to market risk. 'The nature of the economic substance analysis is flexible.'" As to the second argument the court concluded, "Because the Indictment alleges that the all-in fee was integral to the tax shelters, such a formulation is particularly appropriate. Indeed, ignoring fees associated with a tax shelter conflicts with rational decision making – absent tax benefits, no rational investor would entertain an investment where the total costs exceeded any potential return. Finally, as to the third argument, the court concluded, "While the Indictment describes transactions apparently modeled on *Helmer*, its center of gravity focuses on the shelters as a

whole and the fact that in the aggregate they were shams. Thus, Defendants' technical adherence to the contingent liability rule articulated in *Helmer* is irrelevant. The economic substance doctrine is designed to ferret out improper conduct 'despite literal compliance' with tax laws.

5. **Since the same penalty statute applies, the principle of this estate tax penalty case should also apply to late payment of income taxes.** *Baccei v. United States*, 632 F.3d 1140(9th Cir. 2/16/11). In *United States v. Boyle*, 469 U.S. 241 (1985), which involved a § 6651(a)(1) penalty for failure to timely file an failure to an estate tax return, the Supreme Court held that reliance on an accountant, lawyer, or other agent to file the return is not "reasonable cause" for late filing. In another estate tax case, The Ninth Circuit (Judge Burgess) extended this principle to the § 6651(b) penalty to timely pay a tax, holding that the taxpayer's reliance on an accountant, lawyer, or other tax advisor to seek an extension of time to pay the estate tax was not "reasonable cause" for the late payment.

6. **The Tax Court won't waste time or paper on frivolous arguments! Or will it?** *Wnuck v. Commissioner*, 136 T.C. No. 24 (5/31/11). The IRS determined a deficiency based on the taxpayer's unreported wages. At the trial the taxpayer admitted, "I exchanged my skilled labor and knowledge for pay." In a bench opinion the Tax Court held sustained the deficiency, ruling that the taxpayer's arguments were frivolous, imposed a \$1,000 § 6673(a) penalty, and warned the taxpayer that if he repeated his frivolous positions he faced the risk of a larger penalty. On the taxpayer's motion for reconsideration on the grounds that the court had not adequately addressed his arguments, Judge Gustafson wrote a magisterial full opinion, denying the motion for reconsideration and holding that the taxpayer was not entitled to a court opinion addressing his frivolous arguments. While the opinion did not directly answer the substance of the frivolous arguments, it did show why the arguments were frivolous. It also increased the penalty to \$5,000, and warned taxpayer that further frivolous arguments would subject him to a penalty of up to \$25,000.

- Judge Gustafson stated at the outset:

If one is genuinely seeking the truth, if he focuses on what is relevant, and if he confines himself to good sense and logic, then the number of serious arguments he can make on a given point is limited. However, if one is already committed to a position regardless of its truth, if he is willing to say anything, if he is willing to ignore relevance, good sense, and logic, and if he is simply looking for subjects and predicates to put together into sentences in ostensible support of a given point, then the number of frivolous arguments that he can make on that point is effectively limitless. When each frivolous argument is answered, there is always another, as long as there are words to be uttered. Such arguments are without number. Consequently, a Court that decides cases brought by persons willing to make frivolous arguments – such as "tax protesters" or "tax defiers" [fn. 2] – would by definition never be finished with the task of answering those frivolous arguments.

- That notable footnote [fn. 2] explained as follows:

Persons who make frivolous anti-tax arguments have sometimes been called "tax protesters". Section 3707 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 778, provided that "The officers and employees of the Internal Revenue Service \*\*\* shall not designate taxpayers as illegal tax protesters", because Congress was "concerned that taxpayers may be stigmatized", S. Rept. 105-174, at 105 (1998), 1998-3 C.B. 537, 641. This prohibition applies only to IRS employees and not to the courts; and we use here the alternative term "tax defier" for a reason having nothing to do with any supposed stigma attached to being a "zero returns" or who otherwise try to shirk their civic responsibility, evade their fair share of the tax burden, waste tax enforcement resources, and clog the courts with pointless lawsuits are simply scoff-laws. They enjoy the benefits of American security and stability while

refusing to shoulder their portion of the burden. They are not protesters but are defiers.

7. Mistakes that were the result of “confusion, inattention to detail, or pure laziness” of a tax advisor who was the vice president of taxes were not attributable to “reasonable cause,” but when the same tax advisor acted as an independent consultant between stints as a corporate employee and made those same mistakes, the taxpayers’ reliance was in good faith. Huh! Seven W. Enterprises, Inc. v. Commissioner, 136 T.C. No. 26 (6/7/11). The IRS asserted § 6662 accuracy related penalties for 2000 through 2003 with respect to the underpayment of the personal holding company tax. For certain years during that period, William Mues, a CPA, prepared the 2000 and 2001 tax returns for one of the taxpayer corporations and the 2001 return for another of the taxpayer corporations as an independent consultant. In 2002, the taxpayer corporations’ group hired Mues as vice president of taxes, and in that capacity he prepared and signed, on behalf of one of the taxpayer corporations its 2001, 2002, and 2003 tax returns and the 2002, 2003, and 2004 tax returns of another of the taxpayer corporations. The taxpayers contended that they had reasonable cause for their underpayments and acted in good faith and that they reasonably relied on Mues’s advice in 2000 when he served as a consultant and in 2001 through 2004 when he served as vice president of taxes. The Tax Court (Judge Foley) held that even though Mues had been an employee of the taxpayer corporations from 1990 until January 2001 and during that time period executed various tax documents on behalf of the taxpayer corporations, at the time he signed the tax returns as an independent consultant, he was acting as an independent consultant and not as an employee. Because he was an “experienced and knowledgeable tax professional, with all of the relevant information necessary to prepare the return” the taxpayer relied in good faith on Mues to accurately and correctly prepare the 2000 return, even though he made several mistakes in applying the personal holding company tax rules. However, with respect to the 2001 through 2004 returns, the taxpayer corporations did not satisfy the good faith reliance test. For those years, Mues was a corporate employee acting on behalf of the corporations, not an independent advisor. Because he was not a person “other than the taxpayer” the “good faith reliance” defense to the penalties was not available. Furthermore, the taxpayers did not have “reasonable cause” for the understatements. “It is unclear whether [taxpayers’] myriad of mistakes was the result of confusion, inattention to detail, or pure laziness, but we are convinced that petitioners and Mues failed to exercise the requisite due care. ... [The taxpayers’] repeated audit adjustments relating to multiple IRS audits coupled with Mues’ experience, expertise, and education further bolster [the] conclusion that [the taxpayers] failed to exercise ordinary business care and prudence as to the disputed items.”

8. **Yes, it’s my return but can’t I rely on my CPA’s transcription and arithmetic skills? Held: Reliance on a return preparer who omits a \$3.4 million gain on a transaction in which the taxpayer personally participated and for which he received a Form-1099 was not good faith reasonable reliance.** Woodsum v. Commissioner, 136 T.C. No. 29 (6/13/11). In 2006 the taxpayers realized a \$3.4 million gain on “swap” transaction in which one of the taxpayers, who was a managing director of a private equity investment firm, was personally involved. The taxpayers received a Form 1099-MISC, Miscellaneous Income, that reported the payment. The taxpayers retained a firm with a lawyer and a certified public accountant to prepare their 2006 income tax return and gave the firm all the over 160 information returns they had received from third-party payors, including the Form 1099-MISC reporting the \$3.4 million gain. The taxpayers’ 115-page return that the firm prepared reported \$29.2 million of AGI, but omitted the \$3.4 million from the swap transaction. The taxpayers briefly reviewed the return on the due date but did not compare or match the items of income reported on the Form 1040 and its schedules with the information returns that the third-party payors had provided before they signed and filed the return. When the IRS asserted a deficiency for the \$3.4 million gain and § 6662 substantial understatement penalty, the taxpayers conceded the deficiency with respect to the gain but contested the penalty on the grounds of “reasonable cause” and good faith reliance on their tax return preparer. The Tax Court (Judge Gustafson)

upheld the penalty. Even though he “assumed” that the taxpayer’s were unaware of the omission when the signed and filed the return, they “failed to make sure that all their income items were reported on the return that [the return preparer] had prepared. The court reasoned that “to constitute ‘advice’ within the definition of [Reg. § 1.6662-4(c)(2)] the communication must reflect the adviser’s ‘analysis or conclusion.’” The taxpayer must show that he relied on the advisors “judgment.” The taxpayers did not rely on the preparer’s judgment, because “[n]o ‘special training’ was required for Mr. Woodsum to know that the law required him to include on that return an item of income that he had received and that Deutsche Bank had reported on Form 1099.” Furthermore, even though Reg. § 1.6664-4(b)(1) provides that “[a]n isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith,” assuming that the omission was an innocent oversight by the return preparer, the taxpayers’ review of the return was not reasonable under the circumstances. Although a taxpayer is not required to duplicate the work of his return preparer, and an omission of an income item in a return prepared by a third party is not necessarily fatal to a finding of reasonable cause and good faith on the taxpayer’s part if the taxpayer conducts a review of his third-party prepared return with the intent of ensuring that all income items are included, that effort must be reasonable under the circumstances. In this case, the taxpayers failed to demonstrate that they made a reasonable effort to review the return. The taxpayer had personally ordered the transaction that gave rise to the income, and had received a Form 1099–MISC reporting that income. The amount should have appeared on Schedule D as a distinct item, but it was omitted. The taxpayers’ “‘review’ of the defective return was of an unknown duration and that it consisted of the preparer turning the pages of the return and discussing various items.” The \$3.4 million understatement “was substantial not only in absolute terms but also in relative terms (i.e., it equaled about 10 percent of petitioners’ adjusted gross income). A review undertaken to ‘make sure all income items are included’ ... or even a review undertaken only to make sure that the *major* income items had been included—should, absent a reasonable explanation to the contrary, have revealed an omission so straightforward and substantial.” Finally, the court concluded as follows:

Mr. Woodsum terminated the swap ahead of its set termination date because his watchful eye noted that it was not performing satisfactorily as an investment. That is, when his own receiving of income was in question, Mr. Woodsum was evidently alert and careful. But when he was signing his tax return and reporting his tax liability, his routine was so casual that a half-million-dollar understatement of that liability could slip between the cracks. We cannot hold that this understatement was attributable to reasonable cause and good faith.

• If this CPA cannot copy and cannot add, he is nevertheless not subject to preparer penalties because this was an isolated mistake. The one of us who uses a CPA to prepare his tax returns is outraged that a taxpayer who employs a CPA to prepare his income tax return cannot rely on the CPA’s transcription and arithmetic skills.

9. **Canal opinion redux? Paschall v. Commissioner, 137 T.C. No. 2 (7/5/11).** Through a series of convoluted preplanned transactions designed by Grant Thornton that the Tax Court found to lack economic substance, the taxpayer in essence moved approximately \$1.3 million from a traditional IRA to a Roth IRA, without paying any taxes. The IRS asserted that he had made excess contributions to a Roth IRA. The taxpayer had filed timely Forms 1040 for the years in issue, but failed to file Forms 5329 reporting the excess contributions for the years in issue. More than three years after the due date for the Forms 1040 for the years in issue, the IRS proposed § 4973 excise tax assessments. The taxpayer asserted that the statute of limitations had run, but the Tax Court (Judge Wherry) held that the filing of the Forms 1040 did not start the statute of limitations running for purposes of the § 4973 excise tax in the absence of accompanying Forms 5329. Section 6651(a)(1) failure to file a required return penalties were sustained. The taxpayer did not demonstrate reasonable cause and “good faith” to mitigate the penalties. The taxpayer paid his advisors a flat fee of \$120,000, which was payable only if the transaction was completed, and relied solely on the advice of the advisors promoting

the transaction; the tax advisors were not independent. Furthermore, “Paschall should have realized that the deal was too good to be true.”

Mr. Paschall had doubts, repeatedly asking whether the Roth restructure was legal. Despite these doubts, he never asked for an opinion letter or sought the advice of an independent adviser, including Mr. Jaeger, who was preparing his tax returns at the time he met Mr. Stover. This was even after he received a letter warning him that there might be problems with the Roth restructure and that his name was being turned over to the IRS.

a. **Different taxpayer, same scam, same tax advisors, same result, this time citing and quoting *Canal*.** Swanson v. Commissioner, T.C. Memo. 2011-156 (7/5/11). This case involved a transaction substantially similar to *Paschall*, *supra*, if not essentially identical. The taxpayer conceded the substantive excise tax penalty issue and contested only the penalty issue, which he lost. The court (Judge Wherry) rejected the taxpayer’s claim reasonable cause defense to the § 6662 penalties. The taxpayer claimed reliance on his tax advisors, who participated in structuring the transaction. In rejecting the taxpayer’s argument, Judge Wherry quoted from *Canal Corp. v. Commissioner*, 135 T.C. 199, 218 (2010): “Courts have repeatedly held that it is unreasonable for a taxpayer to rely on a tax adviser actively involved in planning the transaction and tainted by an inherent conflict of interest”. Judge Wherry found that “at a minimum” the tax advisors on whom the taxpayer relied “had a conflict of interest and were not independent” because they “set up the various entities and coordinated the deal ‘from start to finish’.” They “were paid ‘a flat fee for implementing \*\*\* [the Roth restructure] and wouldn’t have been compensated at all if \*\*\* [Mr. Swanson] decided not to go through with it.’ Therefore [the taxpayers] cannot argue that their reliance on [the tax advisors] establishes reasonable cause and good faith.”

10. **“Same taxpayer” really does mean the same taxpayer.** Energy East Corp. v. United States, 107 A.F.T.R.2d 2011-2606 (6/20/11). Section 6621(d) deals with overlapping periods of underpayment and overpayment by the “same taxpayer” by imposing a net interest rate of zero on the equivalent underpayment and overpayment for the period of the overlap. Energy East Corporation filed a refund claim, seeking to offset the amount it underpaid in 1999 with amounts two of its subsidiaries overpaid from 1995–97, even though consolidation did not occur until 2000 and 2002. The Court of Appeals for the Federal Circuit (Judge Gajarsa) held that § 6621(d) did not apply in this situation. The parent and the subsidiaries were not the same taxpayer in the pre-consolidation years that the underpayments and overpayments were made. The court rejected the taxpayer’s argument that § 6621(d) merely requires taxpayers to be same only as of time netting claim was filed. The court rejected the taxpayer’s alternative argument that § 6621(d) allows interest netting when two or more corporations file consolidated returns for years during which interest accrues.

11. **Does he go to “Club Fed” or do “hard time”?** United States v. Cooper, 108 A.F.T.R.2d 2011-5815 (10th Cir. 8/15/11). The Tenth Circuit upheld the criminal conviction for wire fraud under 18 U.S.C. § 1343 and mail fraud under 18 U.S.C. § 1341 of an individual who was the founder, president, and CEO of Renaissance, The Tax People, Inc., a corporation that marketed and sold tax materials — the “Tax Relief System” — and a bundle of services — Platinum Tax Advantage — aimed at home based businesses. The package included a scheme to enable anyone associated with Renaissance to avoid paying taxes on their W-2 income through the use of the “W-4 Exemption Increase Estimator” and fraudulently claimed deductions, including the cost of vacations, “wages/allowance paid to children,” commuting miles, and “unreasonable percentage use of the home for business purposes.”

• Somehow the jury had acquitted him of aiding and abetting in the preparation of fraudulent returns under § 7602(2).

12. **Enjoy being enjoined.** United States v. Stover, 108 A.F.T.R.2d 2011-5837 (8th Cir. 8/16/11). The Eighth Circuit upheld a permanent injunction under § 7408 against an accountant barring him from promoting his “Parallel C,” “ESOP/S,” or “Roth/S” fraudulent tax evasion schemes.

## B. Discovery: Summonses and FOIA

1. **Appraiser's work papers are not protected by privilege when the appraisal is part of the tax return.** United States v. Richey, 632 F.3d 559 (9th Cir. 1/21/11). The Court of Appeals held that the work papers of an appraiser hired by the taxpayer's lawyer to provide a valuation for a conservation easement contributed to charity were not protected by attorney-client privilege. The appraisal was required by Reg. § 1.170A-13(c)(1) and was attached to the taxpayer's tax return. "[A]ny communication related to the preparation and drafting of the appraisal for submission to the IRS was not made for the purpose of providing legal advice, but, instead, for the purpose of determining the value of the Easement." Similarly, the file was not protected by the work product doctrine, because the materials were not prepared "in anticipation of litigation." Unless an appraisal had been attached to the return, the taxpayers would not have been entitled to any deduction at all. "Had the IRS never sought to examine the Taxpayers' 2003 and 2004 federal income tax returns, the Taxpayers would still have been required to attach the appraisal to their 2002 federal income tax return. Nor is there evidence in the record that Richey would have prepared the appraisal work file differently in the absence of prospective litigation."

• Query whether FIN 48 workpapers would be protected by work product privilege when a Schedule 1120-UTP prepared using those workpapers is part of a tax return? Note also the possibility of disclosure to the IRS by a whistleblower.

2. **You can't use the third party summons notice requirement as a heads-up to clean out the bank account.** Viewtech, Inc. v. United States, 108 A.F.T.R.2d 2011-5683 (9th Cir. 8/10/11). Section 7609(c)(1)(D)(i) excepts from the third-party summons notice requirement any summons issued in aid of collection of an assessment of tax against the person with respect to whose liability the summons is issued. In construing the application of this provision in *Ip v. United States*, 205 F.3d 1168 (9th Cir. 2000), the Ninth Circuit reasoned that "giving taxpayers notice in certain circumstances would seriously impede the IRS's ability to collect taxes," as would giving notice to fiduciaries or transferees of the taxpayer. It therefore concluded that the clause (i) exception should be given a limited reading to avoid vitiating the legislative purpose. In the instant case the court applied the § 7609(c)(1)(D)(i) to a summons issued to a bank with respect to a corporation in which the taxpayer owned 100 percent of the stock in one year and 97 percent of the stock in another year, and of which he was an officer. "This close legal relationship is sufficient to give [the taxpayer] the requisite interest in the Viewtech bank account such that Viewtech is disqualified from receiving notice under the clause (i) exception." Because the corporation was not entitled to notice, it had no standing to seek to quash the summons.

3. **You can't hide your foreign bank account records behind the Fifth Amendment.** M.H. v. United States, 108 A.F.T.R.2d 2011-5880 (9th Cir. 8/19/11). M.H. was the target of a grand jury investigation seeking to determine whether he used secret Swiss bank accounts to evade paying federal taxes. The District Court granted a motion to compel his compliance with a grand jury subpoena *duces tecum* demanding that he produce certain records related to his foreign bank accounts. The District Court declined to condition its order compelling production upon a grant of limited immunity and, pursuant to the recalcitrant witness statute, 28 U.S.C. § 1826, held him in contempt for refusing to comply. The Ninth Circuit upheld the District Court order. The Court of Appeals held that "Because the records sought through the subpoena fall under the Required Records Doctrine, the Fifth Amendment privilege against self-incrimination is inapplicable, and M.H. may not invoke it to resist compliance with the subpoena's command." The records were required to be kept pursuant to the predecessor of 31 C.F.R. § 1010.420.

## C. Litigation Costs

1. **A lawyer doesn't pay himself attorneys fees that can be recovered.** United States v. Hudson, 106 A.F.T.R.2d 7017 (2d Cir. 11/10/10). The Second Circuit affirmed a district court decision holding that a prevailing taxpayer who appears pro se cannot recover under § 7430 an amount representing the value of his own time expended in presenting his case,



but can recover out-of-pocket litigation costs, including court filing fees, postage and delivery charges, transportation (mileage), and parking.

2. **Here's a case of nonliteral interpretation of the Code that was taxpayer favorable. We didn't know that court can waive sovereign immunity without a clear statutory rule.** Reynoso v. United States, 108 A.F.T.R.2d 2011-5654 (N.D. Cal. 8/8/11). In this refund case the taxpayer recovered over 80 percent of the refund sought, and the court awarded attorney's fees under § 7430 because the government's position was not substantially justified. The court also awarded attorney's fees with respect to the taxpayer's administrative refund claim, rejecting the government's argument that because § 7430(c)(7) defines the term "position of the United States" with respect to administrative proceedings as the position taken "as of the earlier of: (i) the date of the receipt by the taxpayer of the notice of decision of the Office of Appeals, or (ii) the date of the notice of deficiency," and in the refund claim the taxpayer never received a notice of decision from the IRS Office of Appeals or a notice of deficiency, the government has not taken a "position" with respect to taxpayer's case at the administrative level. Without dealing with any technical interpretation of the statutory language, the court simply concluded that the IRS had taken an administrative position:

The IRS's failure to respond to Plaintiff's repeated requests for his refund and for the return of the unapplied portion of the cash bond was tantamount to a denial of those requests. The government cannot insulate itself from paying attorney's fees by simply ignoring a refund request instead of issuing a formal denial. The Court thus rejects the government's contention that it did not take a "position" prior to litigation in this case. Plaintiff is therefore entitled to costs and fees incurred at the administrative level.

#### **D. Statutory Notice of Deficiency**

1. **If you really owe the tax and have already paid it you can't it get it back on an IRS procedural foot-fault.** Principal Life Insurance Company v. United States, 95 Fed. Cl. 786 (11/12/10). An assessment is necessary only for the IRS to collect taxes that have not been paid. A tax liability paid before the deadline for payment will not be subject to refund merely because the IRS fails to timely assess the tax or assesses it beyond the statute of limitations.

2. **Did the malefactor escape on a technicality or did the IRS chase the wrong guy as the malefactor?** Shockly v. Commissioner, T.C. Memo. 2011-97 (5/2/11). The IRS sought to impose transferee liability (for corporate income taxes) on Shockly (an officer/shareholder who sold corporate stock in a Midco transaction) and Shockly filed a Tax Court petition seeking dismissal of the proceeding for lack of jurisdiction because the statute of limitations had run. The Tax Court (Judge Cohen) ruled in favor of Shockly. At the time the IRS sent to the transferor corporation (and Shockly) the deficiency notice with respect to the asserted corporate tax liability, the IRS knew that it had not been sent to the transferor's last known address. In response to that deficiency notice Shockly, who was a former corporate officer of the transferor, had filed petition seeking dismissal of the proceeding for lack of jurisdiction because of the absence of proper notice. Because the Tax Court previously had held that the deficiency notice with respect to which the petition was filed was invalid, in the instant case it held that the period of limitations was not suspended. Thus, the notice determining that Shockly was subject to transferee liability was invalid because it was beyond the period of limitations. Because the statute of limitations was not suspended by the earlier invalid notice and the petition in response to that notice, the period of limitations on transferee liability under § 6901(c) – one year after the expiration of the period of limitation for assessment against the transferor – had expired.

#### **E. Statute of Limitations**

1. **The courts hold that overstating basis is not the same as understating gross income, but the Treasury Department ultimately plays its trump card by promulgating regulations.** Section 6501(e)(1) extends the normal three-year period of limitations to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. Section 6229(c)(2) provides a similar

extension of the statute of limitations under § 6229(a) for assessments arising out of TEFRA partnership proceedings. A critical question is whether the six year statute of limitations applies if the taxpayer overstates basis and as a consequence understates gross income.

a. **The Tax Court says overstating basis is not the same as understating gross income.** Bakersfield Energy Partners, LP v. Commissioner, 128 T.C. 207 (6/14/07). The taxpayer overstated basis, resulting in an understatement of § 1231 gain. Looking to Supreme Court precedent under the statutory predecessor of § 6501(e) in the 1939 Code (*Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958)), from which the six-year statute of limitations in § 6229(c)(2) is derived and to which it is analogous, the Tax Court concluded that this understated gain was not an omission of “gross income” that would invoke the six year statute of limitations under § 6229(c)(2) applicable to partnership audits.

b. **The Ninth Circuit likes the way the Tax Court thinks: *Bakersfield Energy Partners* is affirmed.** Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d 767 (9th Cir. 6/17/09). The Ninth Circuit affirmed the Tax Court on the grounds that the language at issue in the instant case was the same as the statutory language interpreted in *Colony*. The court noted, however, that “The IRS’s interpretation of § 6501(e)(1)(A) is reasonable.”

c. **And a judge of the Court of Federal Claims agrees.** Grapevine Imports, Ltd v. United States, 77 Fed. Cl. 505 (7/17/07), *rev’d*, 636 F.3d 1368 (Fed. Cir. 3/11/11). In a TEFRA partnership tax shelter case, the Court of Federal Claims (Judge Allegra) held that the § 6501(e) 6-year statute of limitations does not apply to basis overstatements, citing *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). Section 6501(e), rather than § 6229(c)(2) as in *Bakersfield Energy Partners, LP*, applied because in earlier proceedings in the instant case (71 Fed. Cl. 324 (2006)), the court had held that § 6229 did not create an independent statute of limitations, but instead only provides a minimum period for assessment for partnership items that could extend the § 6501 statute of limitations, and because the FPAA was sent within this six-year statute of limitations under § 6229(d) the statute of limitations with respect to the partners was suspended.

d. **But a District Court in Florida disagrees.** Brandon Ridge Partners v. United States, 100 A.F.T.R.2d 2007-5347 (M.D. Fla. 7/30/07). The court refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. The court reasoned that as a result of subsequent amendments to the relevant Code sections, the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. [“In the case of a trade or business, the term “gross income” means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.”] The court reasoned that to conclude otherwise would render § 6501(e)(1)(A)(i) superfluous. Because the transaction at issue was the partnership’s sale of stock, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners and partnership returns (and statements attached thereto), taken together “failed to adequately apprise the IRS of the true amount of gain on the sale of the ... stock.” Thus, the partnership did not show that the extended limitations period was inapplicable.

e. **And a different judge of the Court of Federal Claims agrees with the District Court in Florida and disagrees with the prior Court of Federal Claims opinion by a different judge in *Grapevine Imports*.** Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (11/9/07). The court (Judge Miller) refused to follow *Bakersfield Energy Partners* and *Grapevine Imports* and held that the § 6501(e) 6-year statute of limitations does apply to basis overstatements. Judge Miller reasoned that an understatement of “gain” is an omission of gross income, and that omission can result from a basis overstatement as well as from an understatement of the amount realized. Like the *Brandon Ridge Partners* court, Judge Miller concluded that the application of *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), is limited to situations described in § 6501(e)(1)(A)(i), which applies to trade or business sales of goods or services. (“In the case of a trade or business, the term ‘gross income’ means the total of the

amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.”) Because the transaction at issue was the partnership’s sale of a ranch, which was not a business sale of goods or services, the gross receipts test did not apply. On the facts, the partners’ and partnership returns failed to adequately apprise the IRS of the amount of gain in a variant of the Son-of-Boss tax shelter. Accordingly, the partnership did not show that the extended limitations period was inapplicable. The amended order certified an interlocutory appeal and stayed the case pending further court order, because of the split of opinion between *Salman Ranch*, on the one hand, and *Bakersfield Energy Partners* and *Brandon Ridge Partners*, on the other hand.

**f. And the pro-government opinion by Judge Miller is slapped down by the Federal Circuit.** *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09). Following *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), the Federal Circuit (Judge Schall, 2-1) held that “omits from gross income an amount properly includable therein” in § 6501(e)(1)(A) does not include an overstatement of basis. Accordingly, the six-year statute of limitations on assessment did not apply – the normal three-year period of limitations applied. Judge Newman dissented.

**g. But a second District Court sees it the government’s way.** *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D. N.C. 10/21/08), *rev’d*, 197 A.F.T.R.2d 2011-767, *cert. granted*, 9/27/11. The court held that §6501(e) extends the statute of limitations for deficiencies attributable to basis overstatements that result in omitted gross income exceeding 25 percent of the gross income reported on the return. The court refused to follow the Tax Court’s decisions in *Bakersfield Energy Partners* and *Grapevine Imports*, because it concluded that those cases were erroneously decided.

**h. A hiccup from Judge Goeke in the Tax Court: overstated basis in an abusive tax shelter is a substantial omission from gross income that extends the statute of limitations.** *Highwood Partners v. Commissioner*, 133 T.C. 1 (8/13/09). The taxpayers invested through partnerships in foreign currency digital options contracts designed to increase partnership basis and generate losses marketed by Jenkens & Gilchrist (Son of Boss and miscellaneous other names). After expiration of the three-year statute of limitations, the IRS issued an FPAA to the partnership based on the six-year statute of §6501(e)(1) applicable if there was a greater than 25 percent omission of gross income on each partner’s or the partnership’s return. The court (Judge Goeke) held that the digital options contracts produced § 988 exchange gain on foreign currency transactions, which, under the regulations, are required to be separately stated. The long and short positions of the options contracts were treated as separate transactions. Thus, failure to report the gain on the short position, not offset by losses on the accompanying stock sale, represented an omission of gross income. The court also rejected the taxpayer’s argument that because the IRS asserted that the options transactions should be disregarded in full, there can be no omission of gross income from the disregarded short position. Finally, the court refused to apply the adequate disclosure safe harbor of § 6501(e)(1)(A)(ii) because the taxpayer’s netting of the gain and loss from the long and short positions was intended to mislead and hide the existence of the gain and did not apprise the IRS of the existence of the gain.

**i. But Judge Haines follows the Tax Court orthodoxy.** *Beard v. Commissioner*, T.C. Memo. 2009-184 (8/11/09), *rev’d*, 633 F.3d 616 (7th Cir. 1/26/11). In a basis offset deal involving contributions of long and short positions in Treasury notes contributed to S corporations, the court (Judge Haines) granted summary judgment to the taxpayer holding that the basis overstatement attributable to the short sale was not an a substantial omission of gross income. Because the transaction involved Treasury notes, there were no § 988 issues involved. This holding is consistent with *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09).

**j. And the IRS loses again in the Tax Court.** *Intermountain Insurance Service of Vail v. Commissioner*, T.C. Memo. 2009-195 (9/1/09). The court (Judge Wherry), again following *Bakersfield Energy Partners LP v. Commissioner*, 128 T.C. 207 (2007), granted summary judgment to the taxpayer holding that a basis overstatement is not a

substantial omission from gross income that triggers the six year extended statute of limitations under § 6229.

**k. Finally, the IRS gets the upper hand with temporary regulations.** T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/24/09). Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T both provide that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold, gross income otherwise has the same meaning as under § 61(a). The regulations add that, “[i]n the case of amounts received or accrued that relate to the disposition of property, and except as provided in paragraph (a)(1)(ii) of this section, gross income means the excess of the amount realized from the disposition of the property over the unrecovered cost or other basis of the property. Consequently, except as provided in paragraph (a)(1)(ii) of this section, an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income for purposes of section 6229(c)(2).”

**1. But the IRS still suffers from a hangover in cases on which the extended statute had run before the effective date of the regulations.** UTAM, Ltd v. Commissioner, T.C. Memo. 2009-253 (11/9/09), *rev'd*, 107 A.F.T.R.2d 2011-2639 (D.C. Cir. 6/21/11). Judge Kroupa followed Bakersfield Energy Partners to hold that the statute of limitations is not extended to six years pursuant to § 6229(c)(2) or § 6501(e)(1)(A) as a result of a basis overstatement that causes gross income to be understated by more than 25 percent.

• Although the date of the decision was after the effective date of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the result was dictated by prior law effective when the FPAA was issued in 1999.

**m. Judge Wherry shoves it up the Commissioner all the way to his “Colon(-y)” in a reviewed Tax Court decision that holds the Temporary Regulations invalid.** Intermountain Insurance Service of Vail v. Commissioner, 134 T.C. 211 (5/6/10) (reviewed, 7-0-6), *supplementing* T.C. Memo. 2009-195 (9/1/09) (granting summary judgment to the taxpayer, holding that a basis overstatement is not a substantial omission from gross income that triggers the six year extended statute of limitations under § 6229), *rev'd*, 107 A.F.T.R.2d 2011-2613 (D.C. Cir. 6/21/11). On IRS motions to reconsider and vacate in light of Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, the Tax Court (Judge Wherry) held that the Supreme Court’s opinion in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), “unambiguously forecloses the [IRS] interpretation’ ... and displaces [the] temporary regulations.” The first ground was that the temporary regulations were specifically limited their application to “taxable years with respect to which the applicable period for assessing tax did not expire before September 24, 2009,” and in this case that period was not open as of that date. The second ground was that the Supreme Court had held in *Colony* that the statute was unambiguous in light of its legislative history, and foreclosed temporary regulations to the contrary.

• Judges Halpern and Holmes concurred in the result. They stated that they were not persuaded by either of the majority’s analyses, but that the temporary regulations should be invalidated on procedural grounds for failure to comply with the Administrative Procedure Act’s notice-and-comment requirement.

**n. “Tax Court, we’ll see ya at high noon in front of the courts of appeals,” says the IRS.** T.D. 9511, Definition of Gross Income, 75 F.R. 78897 (12/17/10). The IRS and Treasury have finalized amendments to Regs. §§ 301.6229(c)(2)-1 and 301.6501(e)-1, replacing Temp. Reg. §§ 301.6229(c)(2)-1T and 301.6501(e)-1T, T.D. 9466, Definition of Omission from Gross Income, 74 F.R. 49321 (9/24/09). The final regulations are identical to the Temporary Regulations in providing that for purposes of determining whether there is a substantial omission of gross income, gross income as it relates to a trade or business includes the total amount received from the sale of goods or services, without reduction for the cost of goods sold, gross income otherwise has the same meaning as under § 61(a).

• The IRS and Treasury declared in the preamble that they believed that the Tax Court's decision in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. No. 11 (5/6/10), invalidating the Temporary Regulations, was erroneous:

The Treasury Department and the Internal Revenue Service disagree with *Intermountain*. The Supreme Court stated in *Colony* that the statutory phrase "omits from gross income" is ambiguous, meaning that it is susceptible to more than one reasonable interpretation. The interpretation adopted by the Supreme Court in *Colony* represented that court's interpretation of the phrase but not the only permissible interpretation of it. Under the authority of *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982–83 (2005), the Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of "omits from gross income," particularly as it is used in a new statutory setting.

• According to the preamble, the final regulations have been clarified to emphasize that they only apply to open tax years, and do not reopen closed tax years. However, the preamble states:

The Tax Court's majority in *Intermountain* erroneously interpreted the applicability provisions of the temporary and proposed regulations, which provided that the regulations applied to taxable years with respect to which "the applicable period for assessing tax did not expire before September 24, 2009." The Internal Revenue Service will continue to adhere to the position that "the applicable period" of limitations is not the "general" three-year limitations period. ... Consistent with that position, the final regulations apply to taxable years with respect to which the six-year period for assessing tax under section 6229(c)(2) or 6501(e)(1) was open on or after September 24, 2009.

• The Supreme Court's decision in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), holding that Treasury Regulations are entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), will play a major role in who wins this shoot-out

◦ **And Government wins in the Seventh Circuit, without any help from the Temporary Regulations.** *Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 1/26/11), rev'g T.C. Memo 2009-184 (8/11/09). The Seventh Circuit, in an opinion by Judge Evans, reversed the Tax Court's decision that an overstatement of basis results in an omission of gross income that triggers the six year statute of limitations under § 6501(e)(1)(A). In a "very carefully reasoned opinion," (*but see* the *Burks* case, below) the court concluded that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958) was not controlling. The Seventh Circuit reasoned that *Colony* was both factually different – *Colony* involved an overstatement of the basis of lots held by a real estate developer for sale to customers in the ordinary course of business, while the instant case involved an overstatement of basis in a partnership interest in a Son-of-BOSS tax shelter transaction – and legally different because of changes between the 1939 Code § 275(c), which was interpreted in *Colony* and 1954 Code § 6501(e). The court held that "*Colony's* holding is inherently qualified by the facts of the case before the Court, facts which differ from our case, where the Beards' omission was not in the course of trade or business. From the perspective of statutory interpretation, the court focused on the impact of the addition of § 6501(e)(1)(B)(ii) in the 1954 Code, which provides that "in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." Quoting *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), the court stated "[w]e conclude that the enactment of subsection (ii) of section 6501(e)(1)[(B)] makes it apparent that the six year statute is intended to apply where there is either a complete omission of an *item of income* of the requisite amount or misstating of the nature of an item of income which places the "commissioner ... at a special disadvantage in detecting errors." (emphasis supplied). Even

though it distinguished *Colony* and concluded that it was “left without precedential authority,” the court nevertheless concluded that because the language of § 6501(e)(1)(A) at issue in the case was identical to the language of § 275(c) interpreted in *Colony*, it was required to interpret § 6501(e)(1)(A) in light of *Colony*. However, it also reasoned that it must “bear in mind” that Congress did add subsections (i) and (ii) to § 6501(e)(1)(B) and that “the section as a whole should be read as a gestalt.” In analyzing *Colony*, the court noted that the Supreme Court had found § 275(c) to be ambiguous, but was more persuaded by the taxpayer’s argument that focused on the word “omits.” The Seventh Circuit noted that what *Colony* “does not address in depth is ‘gross income’” which is defined generally in Section 61 of the Code as “all income from whatever source derived,” but which is not defined in § 6501(e) except for the special definition in § 6501(e)(1)(B)(i) that applies to trade or business income. The court then went on to hold:

Using these definitions and applying standard rules of statutory construction to give equal weight to each term and avoid rendering parts of the language superfluous, we find that a plain reading of Section 6501(e)(1)(A) would include an inflation of basis as an omission of gross income in non-trade or business situations. ... It seems to us that an improper inflation of basis is definitively a “leav[ing] out” from “any income from whatever source derived” of a quantitative “amount” properly includible. There is an amount-the difference between the inflated and actual basis-which has been left unmentioned on the face of the tax return as a candidate for inclusion in gross income.

• The court was reinforced in its conclusion by the existence of § 6501(e)(1)(B)(i), reasoning that “[i] the omissions from gross income contemplated Section 6501(e)(1)(A) were only specific items such as receipts and accruals, then the special definition in subsection (i) would be, if not superfluous, certainly diminished. The addition of this subsection suggests that the definition of gross income for the purposes of Section 6501(e)(1)(A) is meant to encompass more than the types of specific items contemplated by the *Colony* holding.” The Seventh Circuit considered *Bakersfield Energy Partners v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), and *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 7/30/09), to have been erroneously decided. Finally, the court addressed the parties’ arguments regarding the impact of Temp. Reg. § 301.6501(e)-1T(a)(1)(a). Rather than ruling on the validity of the regulation, however, the court stated that because it did not find *Colony* controlling and reached its decision that the six-year statute of limitations applied on the face of the Code section, it would not reach the validity of the regulation. However, in dictum, the court stated that it would be inclined to grant deference to Temp. Reg. § 301.6501(e)-1T(a)(1)(a), even though it was issued without notice and comment, citing *Barnhart v. Walton*, 535 U.S. 212 (2002), for the proposition that “the absence of notice-and-comment procedures is not dispositive to the finding of *Chevron* deference.”

p. **But the Fourth Circuit relied on *Colony* to find for the taxpayer.** *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2/7/11), cert. granted, 9/27/11. The Fourth Circuit (Judge Wynn) held that *Colony* decided that 1954 Code § 6501(e)(1)(A) was unambiguous and that an overstated basis in property is not an omission from gross income that extends the limitations period. It further held that Reg. § 301.6501(e)-1(e) by its plain terms did not apply to the tax year in this case because the six-year limitations period had expired before the regulation was issued. Judge Wynn stated

Like the Ninth and Federal Circuits, we hold that the Supreme Court in *Colony* straightforwardly construed the phrase “omits from gross income,” unhinged from any dependency on the taxpayer’s identity as a trade or business selling goods or services. There is, therefore, no ground to conclude that the holding in *Colony* is limited to cases involving a trade or business selling goods or services.

Further, the Supreme Court’s discussion of the legislative history behind former § 275(c) is equally compelling with regard to current § 6501(e)(1)(A). The language the Court construed in former § 275(c) “omits from gross income an

amount properly includable therein”—is identical to the language at issue in § 6501(e)(1)(A). Because there has been no material change between former § 275(c) and current § 6501(e)(1)(A), and no change at all to the most pertinent language, we are not free to construe an omission from gross income as something other than a failure to report “some income receipt or accrual.” .... Thus, we join the Ninth and Federal Circuits and conclude that *Colony* forecloses the argument that Home Concrete’s overstated basis in its reporting of the short sale proceeds resulted in an omission from its reported gross income.

- Judge Wynn concluded that the regulation was “not entitled to deference.”

q. As did the Fifth Circuit, which chided the Seventh Circuit for misinterpreting a Fifth Circuit case on which it relied in *Beard. Burks v. United States*, 633 F.3d 347 (5th Cir. 2/9/11). The Fifth Circuit (Judge DeMoss) also held that an overstatement of basis is not an omission from gross income for purposes of § 6501(e)(1)(A). Judge De Moss disagreed with the Seventh Circuit’s interpretation of *Phinney v. Chambers*, 392 F.2d 680 (5th Cir. 1968), as limiting *Colony*, stating that “the Seventh Circuit failed to note the distinct factual pattern presented in *Phinney*, where the taxpayers had misstated the very nature of the item so that the IRS would not have had any reasonable way of detecting the error on the tax return. That is not the case here.”

- In its final footnote, the court stated:

Although we hold that § 6501(e)(1)(A) is unambiguous and its meaning is controlled by the Supreme Court’s decision in *Colony*, we note that even if the statute was ambiguous and *Colony* was inapplicable, it is unclear whether the Regulations would be entitled to *Chevron* deference under *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (2011). See, e.g., *Home Concrete & Supply, LLC v. United States*,—F.3d —, No. 09-2353) 2011 WL 361495, \*7 (4th Cir. Feb. 7, 2011) (declining to afford the Regulations *Chevron* deference because the statute is unambiguous as recognized by the Supreme Court in *Colony*). In *Mayo*, the Court held that the principles underlying its decision in *Chevron* “apply with full force in the tax context” and applied *Chevron* to treasury regulations issued pursuant to 26 U.S.C. § 7805(a). *Id.* at 707. Significantly, in *Mayo* the Supreme Court was not faced with a situation where, during the pendency of the suit, the treasury promulgated determinative, retroactive regulations following prior adverse judicial decisions on the identical legal issue. “Deference to what appears to be nothing more than an agency’s convenient litigating position” is “entirely inappropriate.” *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988). The Commissioner “may not take advantage of his power to promulgate retroactive regulations during the course of a litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations.” *Chock Full O’ Nuts Corp. v. United States*, 453 F.2d 300, 303 (2d Cir. 1971).

Moreover, *Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures, “a consideration identified . . . as a significant sign that a rule merits *Chevron* deference.” 131 S. Ct. at 714. Legislative regulations are generally subject to notice and comment procedure pursuant to the Administrative Procedure Act. See 5 U.S.C. § 553(b)(A). Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. See Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury’s (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158-60 (2008) (noting that the treasury frequently issues purportedly binding temporary regulations open to notice and comment only after promulgation and often denies

the applicability of the notice and comment procedure when issuing its regulations because that requirement does not apply to regulations that are not a significant regulatory action, while continuing to assert that the regulations are entitled to legislative regulation level deference before the courts). That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for prepromulgation notice and comment. See *U.S. Steel Corp. v. U.S. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979).

r. Finally, a court that read *Colony* very very carefully and understands what *Colony* really said and what it really did not say. *Grapevine Imports v. United States*, 636 F.3d 1368 (Fed. Cir. 3/11/11), rev'g 77 Fed. Cl. 505 (2007). The Federal Circuit, in a unanimous panel opinion by Judge Prost, reversed the Court of Federal Claims holding that the six-year statute of limitations does not apply to an understatement of gross income attributable to a basis overstatement. The Court of Federal Claims had relied on the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). However, the Court of Appeals for the Federal Circuit applied Reg. § 301.6229(c)(2)-1 and Reg. § 301.6501(e)-1, after first concluding that the Supreme Court's opinion in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), unambiguously held that a subsequently promulgated Treasury Regulation could overrule a prior judicial decision (including a Supreme Court decision), as long as the regulation was valid under the standards of *Chevron, USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Preliminarily the court found that the regulations, "state that *Colony* did not conclusively resolve the statutory interpretation issue, and that overstatement of basis (outside the trade or business context) can trigger the extended limitations period." A critical point in the court's reasoning was that the decision in *Colony* did not hold that the language in question, which is the language that § 6501(e)(1) has in common with § 275(c) of the 1939 Code that was at issue in *Colony*, was unambiguous.

[The Supreme Court expressly found the predecessor statute ambiguous, and turned to the legislative history to resolve the question. ... ("[I]t cannot be said that the language [of the statute] is unambiguous."). And while it is true that the Court later referred to the updated § 6501(e)(1)(A) as "unambiguous," it did not rely or elaborate on that statement, nor was the updated statute at issue in that case. ... Further, in *Colony* the taxpayer was in the business of land sales, so § 6501(e)(1)(A)(i)'s test for income "in the case of a trade or business" expressly applied. That is not the case here. The ambiguity concerns what to do outside the trade and business context, and the only language in § 6501(e)(1)(A) applicable outside the trade or business context is the same language from the predecessor statute, "omits from gross income an amount." The Supreme Court previously noted that this term was ambiguous as to whether it encompassed an overstated basis. We therefore find *Colony* no bar to our finding that the text of the relevant statutes, standing alone, is ambiguous as to the disposition of this issue.

• Turning to *Chevron* step one analysis, the Court of Appeals concluded that §§ 6229(c)(2) and 6501(e) are ambiguous that the Treasury thus "is entitled to promulgate its own interpretation of these statutes, and to have that interpretation given deference by the courts so long as it is within the bounds of reason."

[The Tax Code's use of the term "omits" suggests that the section is primarily addressed to the return where the taxpayer has "fail[ed] to include or mention" or "le[ft] out" some item rather than misrepresenting it (as by an overstatement of basis). ... But without looking beyond the text itself, we cannot say that the statute forecloses the possibility that a taxpayer's overstated basis might constitute an omission from gross income.

• Turning to the second step of the *Chevron* analysis, which asks whether the regulations constitute "a reasonable policy choice for the agency to make," the court concluded that the regulations are reasonable, even though they depart from the judicial



interpretation of *Colony* and *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009). Next, the court rejected the taxpayer's arguments that the regulations are invalid were because they were "retroactive," noting that in *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), the Supreme Court confirmed that § 7805(b) authorizes retroactive regulations. The court also rejected an argument by the taxpayer – one which we confess not to understand – that the statute of limitation expired upon the entry of judgment by the Court of Federal Claims, notwithstanding rules tolling the period of limitations during a pending appeal. Finally, based on Supreme Court precedent, the court rejected the taxpayer's claim that the Treasury did not have the power to affect the outcome of the appeal by promulgating regulations after the trial court decision and before the appeal was heard.

• The opinion of the Court of Appeals for the Federal Circuit does not directly address the question raised in *Home Concrete & Supply Company, LLC v. United States*, 107 A.F.T.R.2d 2011-768 (4th Cir. 3/11/11), which held that Reg. § 301.6501(e)-1(a)(1)(ii) was not applicable because according to the terms of the regulation it applies only to taxable years with respect to which the statute of limitations remained open on and after Sept. 24, 2009, and the three-year statute of limitations had expired before that date. Again, this is an argument, and a holding, that we simply cannot understand, other than as the taxpayer's and court's expression of gut feelings that it is "dirty pool" for the Commissioner to put his thumb on the regulatory scale to affect an issue pending before a court, even though in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (1/11/11), the Supreme Court appears to have expressly blessed such a tactic, albeit in litigation over an different issue.

s. **Did anyone really expect the Tax Court to roll over and play dead just because the IRS promulgates regulations that says it wins? Carpenter Family Investments v. Commissioner**, 136 T.C. No. 17 (4/25/11). In a reviewed opinion by Judge Wherry, in which only four other judges joined, but with a number of concurrences and no dissents, the Tax Court once again held that the six year statute of limitations under §§ 6501(e) and 6229(c)(2) do not apply to understatements of gross income attributable to basis overstatements. In doing so the court held that final Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T are invalid, just as it had held that in *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 211 (5/6/10), that Temp. Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were invalid. Noting that the case was appealable to the Ninth Circuit, in which *Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9th Cir. 6/17/09), is the controlling precedent, the Tax Court followed the line of reasoning previously applied by it, *Bakersfield Energy Partners*, and some other courts, that the Supreme Court's decision in *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), was not limited to situations involving a trade or business and that it controlled the interpretation of § 6501(e)(1)(A). The court then turned to whether Reg. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), and *Mayo Foundation for Medical Research v. United States*, 131 S. Ct. 704, 711 (1/11/11), and determined that they were not entitled to deference. In this context the court observed that *Mayo* "focuses exclusively on the statutory text at *Chevron* step one and suggests (by negative implication) a disfavor of using legislative history at that stage. We are not persuaded, however, that after *Mayo*, any judicial construction that examines legislative history is automatically relegated to a *Chevron* step two holding by that fact alone." In proceeding to analyze whether under the authority of *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005), the Treasury Department and the IRS have the power to promulgate regulations overturning prior court decision, the court appears first to have concluded that "only if an 'unwise judicial construction' represents a policy choice, must it yield to 'the wisdom of the agency's policy.'" In the end, however, the court appears also to have grounded its decision on what it perceived to be ambiguities in the preamble of T.D. 9511, which promulgated the regulations at issue and which the court infers did not strongly enough invoke a power under *Brand X* as the basis for promulgating the regulations. The final passage of its reasoning as follows:

Even if we read the Supreme Court's recent *Mayo* opinion as a license to categorize most judicial constructions that discuss legislative history as *Chevron* step two decisions, respondent has yet to unabashedly accept the Court of Appeals for the Ninth Circuit's invitation and issue regulations that unequivocally repudiate the *Colony* holding. Unless and until he does so, his hands must remain tied.

- Judge Thornton's concurring opinion, with which Judges Cohen, Halpern, Holmes, and Paris agreed, would have decided the case solely on the grounds that the result "follows from the unambiguous terms of the statute," and there is no compelling reason for the Tax Court to abandon its precedents.

- Judges Halpern and Holmes joined in another concurring opinion discussing the scope and meaning of *Chevron* and *Brand X*.

т. **The Court of Appeals for the Federal Circuit does a 180°.** *Salman Ranch, Ltd. v. Commissioner*, \_\_\_ F.3d \_\_\_, 107 A.F.T.R.2d 2011-2359 (10th Cir. 5/31/11). In a case involving a different tax year for the taxpayer, the Federal Circuit held, see e. and f., above, that the extended statute of limitations did not apply to this partnership for its 1999 year. Subsequently, in *Grapevine Imports v. United States*, 636 F.3d 1368 (Fed. Cir. 3/11/11), see r., above, the Federal Circuit overruled its pro-partnership decision in the 1999 *Salman Ranch* case. In this separate case for this partnership's 2001 and 2002 years, the Tax Court had held collateral estoppel required summary judgment be granted for the partnership. The Tenth Circuit (Judge Seymour) reversed and remanded, holding that collateral estoppel was inapplicable because of an intervening change in law, i.e., the final regulations (see n., above). Judge Seymour based his decision that the final regulations were entitled to *Chevron* deference based upon the Supreme Court's holdings in *Mayo Found. For Med. Educ. & Research v. United States*, 131 S. Ct. 713 (1/11/11); and refused to follow contrary authority among the cases discussed above.

у. **And the government chalks up another victory in front of a panel that really understands the proposition for which *Colony* stands and the propositions for which it really does not stand.** *Intermountain Insurance Service of Vail v. Commissioner*, 107 A.F.T.R.2d 2011-2613 (D.C. Cir. 6/21/11). After a thorough examination of the history of § 275(c) of the 1939 Code, the pre-*Colony* litigation, the *Colony* decision itself, the enactment of § 6501(e) and the relevant changes from § 275(c), and the recent cases on the issue, and the promulgation of Reg. §§ 301.6501(e)-1T(a)(iii) and 301.6229(c)-1T(a)(iii), the Court of Appeals for the District of Columbia, in an opinion by Judge Tatel, reversed the Tax Court and, with a healthy spread of *Mayo*, upheld the regulations, and dismissed the taxpayer's [tautological, in our opinion] argument, which was accepted by the Tax Court (and a few other courts) that the regulations by the terms of their effective date were inapplicable to the transaction in question. The court's opinion carefully explains the source of the statutory ambiguity and why *Colony* did not state that the relevant language was unambiguous, rejecting the less well reasoned opinions of those courts that found *Colony* to have held that the statutory provision was unambiguous. Going a step further, the court concluded that *Colony* simply did not apply to either § 6501(e) or § 6229(c)(2), and that under *Chevron* it was an easy call to uphold the substance of the regulations, while under *Mayo* there were no procedural problems with the manner in which the regulations were promulgated. However, the Court of Appeals remanded the case to the Tax Court to consider Intermountain's alternative argument that Intermountain avoided triggering the extended statute of limitations by "adequately disclos[ing] to the IRS the basis amount it applied in connection with the transaction at issue.

в. **Let's play that tune again.** *UTAM, Ltd v. Commissioner*, 107 A.F.T.R.2d 2011-2639 (D.C. Cir. 6/21/11). The Court of Appeals for the District of Columbia, in a very brief opinion by Judge Randolph, reversed the Tax Court decision (see l., above) on the basis of the court's holding in *Intermountain Insurance Service of Vail v. Commissioner*, 107 A.F.T.R.2d 2011-2613 (D.C. Cir. 6/21/11). Although the Tax Court did not reach the issue of whether § 6229(c) suspends the individual partner's § 6501 limitations period when that period is

open on the date the IRS mailed the FPAA, the Court of Appeals found that a remand on this issue would not serve a useful purpose. Under D.C. Circuit's opinion in *Andantech, L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), the assessment period suspended by § 6229(d) is the partner's open assessment period under § 6501. Thus, the statute of limitations had not run.

w. **The Fifth Circuit stands by its Burks holding, and the government is ready to talk to the Supreme Court.** *R and J Partners v. Commissioner*, \_\_\_ Fed. Appx. \_\_\_ (5th Cir. 9/20/11). In a per curiam opinion the Fifth Circuit followed *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), to hold that the six year statute of limitations of § 65019e) does not apply to basis overstatements and that Reg. § 301.6501(e)-1 is invalid.

• The court noted that "The Commissioner agrees that *Burks* controls the law in the circuit on that question and that the Tax Court correctly applied that law, but took this protective appeal in an effort to obtain a review by the Supreme Court."

x. **The Supreme Court granted certiorari to the Fourth Circuit in *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2/7/11), on 9/27/11.** It declined invitations from the government to consider cases from the Fifth and Seventh Circuits.

2. **A refund of fraudulently reported withholding results in an underpayment.** *Feller v. Commissioner*, 135 T.C. 497 (11/8/10) (reviewed). The taxpayer, who controlled the corporation by which he was employed, fraudulently overstated withholding tax credits on his income tax returns and on the Forms W-2 issued to him for tax years 1992 through 1997. The IRS assessed tax and fraud penalties in 2006, on the theory that there was fraudulent underpayment and that, therefore, pursuant to § 6501(c)(1) the statute of limitations did not bar the assessment. The taxpayer argued that Reg. § 1.6664-2(c)(1) and (g), Ex. (3), which provide that overstated prepayment credits (e.g., overstated withholding) result in underpayments of tax within the meaning of § 6664, was invalid. In a reviewed opinion by Judge Haines (joined by ten other judges), the Tax Court, applying the *Chevron* test (because the case was appealable to the Sixth Circuit, which applies the *Chevron* test to Treasury regulations), upheld the validity of Reg. § 1.6664-2(c)(1) and (g), Ex. (3). The assessments were upheld.

• Judges Wherry and Gustafson (joined by Judge Halpern) dissented and would have invalidated the regulations as an impermissible construction of the statute.

3. **"It takes real chutzpah for Donnelley to demand a refund under these circumstances."** – J. Harvie Wilkinson III. **That sentence seems uncharacteristic from a good ol' Virginia boy, but his birth certificate shows he was born in New York City.** *R.H. Donnelley Corp. v. United States*, 641 F.3d 70 (4th Cir. 3/31/11): The taxpayer filed a timely refund claim with respect to 1991 and 1992 resulting from carrying back approximately \$11 million of excess credits from 1994. In response the IRS conducted an audit and disallowed a large deduction for 1994 and calculated a \$43 million deficiency for 1994, which was not assessed because 1994 was a closed year, the taxpayer having filed its refund claim two days before the statute of limitations expired. Based on this recalculation, the IRS determined that all of the credits had been used in 1994 and none could be carried back. The Court of Appeals (Judge Wilkinson) upheld the IRS's determination, applying the rule of *Lewis v. Reynolds*, 284 U.S. 281 (1932). The court observed as follows.

... Donnelley was not content merely to escape from its tax liability in the first instance. It filed a refund claim two days before the statute of limitations for the assessment of 1994 taxes expired, presumably counting on the fact that the IRS could not investigate any underpayment in time to collect it. That refund claim depended on credits that could be carried back only because Donnelley had misreported its taxes in the first place. It is true that the statute of limitations may protect Donnelley from additional collection, but it does not give Donnelley license to claim a second windfall in the form of a refund. To claim otherwise is almost beyond belief.

• The court then concluded by stating:

No one is entitled a refund who has not actually overpaid his taxes. This axiomatic observation, made first by the Supreme Court in *Lewis* and recognized by this circuit in *Estate of Michael [v. Lulo]*, 173 F.3d 503 (4th Cir. 1999), defeats

this taxpayer's claim. Here, Donnelley has not overpaid its taxes, and we will not allow it to reap where it has not sown.

a. **Although the government can assert underpayments beyond the period of limitations as a defense in refund suits, taxpayers cannot assert overpayments beyond the period of limitations on refunds as a set off against a deficiency.** Brady v. Commissioner, 136 T.C. No. 19 (4/28/11). In reviewing a CDP determination, the Tax Court (Judge Ruwe) held that alleged overpayments in prior years for which the taxpayer had filed timely refund claims, which were denied and with respect to which the taxpayer had failed to file a timely refund suit, could not be taken into account to reduce his liability for the year in question.

4. **Mitigation of limitations permitted where taxpayer was inconsistent.** Anthony v. Commissioner, T.C. Summ. Op. 2011-50 (4/18/11). The Tax Court (Judge Swift) held that a taxpayer who erroneously overstated the amount of her Schedule C closing inventory in the 2004 open year was behaving inconsistently when she asserted that the overstated amount could nevertheless be used as her opening inventory amount in the 2005 year, which had been closed by the statute of limitations. The IRS permitted her to correct the overstatement for 2004 as part of a stipulated decision entered on 12/31/09. In a classic mitigation of limitations scenario under §§ 1311-1314, the deficiency asserted by the IRS on 1/7/10 based on the corrected opening inventory amount for the otherwise closed 2005 year was upheld.

5. **A durable power of attorney is a good thing, right? Not when § 6511(h) is in play.** Platt v. United States, 108 A.F.T.R.2d 2011-5962 (Fed. Cl. 8/19/11). The taxpayer, who suffered from dementia and not able herself to manage her financial affairs, filed a refund claim more than three years after paying the tax. Section 6511(h) tolls the statute of limitations on filing refund claims for any period that the taxpayer is unable to manage his financial affairs by reason of a medically determined physical or mental impairment that will result in death or that has lasted or can be expected to last at least twelve months. The statute is not tolled, however, if another person is authorized to manage the taxpayer's financial affairs. The court held that the taxpayer was not entitled to § 6511(h) relief, because her son had authority under a durable power of attorney to act on her behalf on financial matters.

#### F. Liens and Collections

1. **In this much-discussed case, taxpayer's poverty trumps a proposed levy.** Vinatieri v. Commissioner, 133 T.C. 392 (12/21/09). The taxpayer submitted a settlement offer for delinquent taxes, but the IRS determined to levy on the taxpayer's wages and car. Even though the IRS concluded that the levy would create an economic hardship, the settlement officer determined collection alternatives to the levy, including an installment agreement, an offer-in-compromise, and reporting the account as currently not collectible, were not available because the taxpayer had not filed returns for several years. In a review of a § 6330 CDP hearing, Judge Dawson held that it was unreasonable and an abuse of discretion for the IRS to proceed to levy on the taxpayer's wages and car, because a levy would have left the taxpayer impoverished. Section 6343(a)(1) requires that the IRS must release a levy upon all, or part of, a taxpayer's property if it determines that the levy creates an economic hardship due to the taxpayer's financial condition. Reg. § 301.6343-1(b)(4) provides that a levy creates an economic hardship due to the financial condition of an individual taxpayer and must be released "if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses." Because the taxpayer had demonstrated that a levy would render her unable to pay her reasonable basic living expenses, the IRS was barred from levying. Judge Dawson rejected the IRS's argument that because the taxpayer was not in compliance with the filing requirements for all required tax returns, its determination to levy was not unreasonable.

• The requirement that taxpayer be currently in compliance with his or her obligations to the IRS under its "currently not collectible" ("CNC") program does not apply to relief under § 6343.

a. **Appeals must address credible claims of economic hardship.** Chief Counsel Notice CC-2011-005 (12/22/10). In response to the *Vinatieri* case, the Chief Counsel now requires Appeals to address credible claims of economic hardship.

2. **The IRS has an obligation to cooperate with taxpayers too.** *Azzari v. Commissioner*, 136 T.C. No. 9 (2/24/11). In a CDP proceeding the taxpayer requested the IRS to subordinate its tax lien for unpaid employment taxes to the third-party lender that was lending the taxpayer funds to pay current employment taxes and to enter into an installment agreement with respect to the back taxes. In reviewing the IRS's determination not to grant CDP relief, the Tax Court (Judge Wells) held that the Appeals Office had abused its discretion because it had misinterpreted § 6323(c) and the regulations thereunder (governing the priority of liens in certain commercial financing arrangements). "Although the Commissioner's Appeals Office has discretion under § 6325(d) to determine whether it is in the Government's interest to subordinate a Federal tax lien, it appears that Mr. Lee's refusal to consider petitioner's request to subordinate the lien was based on an error of law. To the extent it was based upon an error of law, his determination constitutes an abuse of discretion." Furthermore, the refusal to consider the taxpayer's request for an installment agreement also was an abuse of discretion. Although the IRS's refusal to consider an installment agreement when the taxpayer is not satisfying current obligations is not generally an abuse of discretion, in this case the IRS's refusal to subordinate its tax lien contributed to the taxpayer falling behind on current employment tax payments, and the taxpayer was denied a chance to become current.

3. **Day trading is dissipation of assets. Well, duh!** *Tucker v. Commissioner*, T.C. Memo. 2011-67 (3/22/11). The taxpayer was a day trader, who at a time he owed the IRS \$39,000, lost \$22,645 in his day trading activities. In calculating the reasonable collection potential for purposes of evaluating the taxpayer's offer in compromise, the Office of Appeals considered his day trading to constitute asset dissipation that warranted rejection of his OIC. The Tax Court (Judge Gustafson) upheld the IRS's determination in a CDP hearing to reject the taxpayer's OIC.

4. **The IRS loses a "battle of the forms."** *Thornberry v. Commissioner*, 136 T.C. No. 16 (4/19/11). The taxpayers' request for a CDP hearing, though it was a "boilerplate form" copied from an internet website, might have set forth legitimate issues, among those that were not legitimate. The IRS's response with a "boilerplate form" that did not address those issues was inappropriate. The letter from the Appeals Office stating that the taxpayers' request for a collection due process hearing would be disregarded because the request was frivolous and intended only to delay or impede the collection of tax constituted a "determination" subject to review by the Tax Court. The court (Judge Dawson) ordered the taxpayers to identify specific issues and the grounds that they wished to raise before issuing any further orders.

5. **What's a little non-ex parte among friends?** *Hoyle v. Commissioner*, 136 T.C. No. 22 (5/23/11). The Tax Court held that neither the ABA Model Code of Judicial Conduct nor a state law Code of Judicial Conduct was relevant to communications between personnel of the IRS Office of Chief Counsel and an Appeals Division officer conducting a CDP hearing. Rev. Proc. 2000-43, 2000-2 C.B. 404, is the relevant authority in nondocketed cases and Chief Counsel Notice CC-2007-006 is the relevant authority in docketed cases, including, as in the instant case, a CDP remand from the Tax Court. Much of the communication in this case was merely ministerial. Furthermore, "[a] request by a hearing officer for legal advice in connection with the remanded CDP case may be handled by the Counsel attorney who is handling the docketed Tax Court case, so long as that attorney did not give legal advice to an originating function (e.g., Collection) concerning the same issue in the same case." The Counsel attorney provided legal advice on specific issues, such as whether the taxpayer could challenge the underlying liability if he had received a notice of deficiency. The Counsel attorney's review of the Appeals Officer's draft supplemental notice of determination was meant to ensure that the supplemental notice of determination on remand complied with the Tax Court's order, and was not an impermissible *ex parte* communication. Thus, there was no prohibited *ex parte* contact.

6. **OICs must be realistic; the taxpayer must feel the pain.** *Johnson v. Commissioner*, 136 T.C. No. 23 (5/31/11). The IRS did not abuse its discretion in rejecting the

taxpayer's offer in compromise of an amount based that was solely on based solely the proceeds available from a single asset and ignoring future disposable income. Reasonable collection potential included some amount of future disposable income.

7. **"When in doubt, the bank wins." – Even against the IRS this time.** Bloomfield Bank v. United States, 107 A.F.T.R.2d 2011-2153 (7th Cir. 5/1/11). Reversing a District Court decision, the Court of Appeals (Judge Posner), held that a mortgage that assigns future rental income to the mortgagee creates a security interest that takes priority over a federal tax lien. The rental income from the property is not a distinct form of property; it is merely proceeds of owning a rented property, as are the sales proceeds.

8. **The divorce bought the taxpayer a second bite at a CDP hearing.** Churchill v. Commissioner, T.C. Memo. 2011-182 (8/1/11). The Tax Court (Judge Holmes) held that it has authority to remand a CDP determination, even though the IRS did not abuse its discretion, where there has been a material change in a taxpayer's factual circumstances between the time of the hearing and the time of the Tax Court review. The taxpayer's divorce after the CDP hearing with respect to an offer in compromise was such a change in circumstances.

### G. Innocent Spouse

1. **That regulation ain't got no equity and it ain't got no empathy, so it's invalid. The Tax Court majority responds to "the sound of [congressional] silence."** Lantz v. Commissioner, 132 T.C. 131 (4/7/09) (reviewed, 12-4). The taxpayer sought equitable relief from joint income tax liability under § 6015(f), but the IRS denied relief on the ground that she had not requested relief within two years from the IRS's first collection action, as required by Reg. § 1.6015-5(b)(1). Consequently, the IRS did not reach the substantive issues of the claim. In a reviewed opinion by Judge Goeke, joined by eleven judges, with four dissents, the Tax Court held Reg. § 1.6015-5(b)(1) to be invalid as applied to § 6015(f) relief. (Following the *Golsen* rule, the Tax Court applied *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), because the Seventh Circuit held in *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 979 (7th Cir. 1998), that regulations issued under general or specific authority of the IRS to promulgate necessary rules are entitled to *Chevron* deference; Reg. § 1.6015-5 was issued under both a general grant of authority under § 7805 and a specific grant of authority in § 6015(h).) The court focused on the explicit inclusion of a two-year deadline in both § 6015(b) and § 6015(c), in contrast to the absence of any deadline in § 6015(f), to find that the regulation was not a reasonable interpretation of the statute under the *Chevron* standard.

"It is generally presumed that Congress acts intentionally and purposely' when it 'includes particular language in one section of a statute but omits it in another'". ... We find that by explicitly creating a 2-year limitation in subsections (b) and (c) but not subsection (f), Congress has "spoken" by its audible silence. Because the regulation imposes a limitation that Congress explicitly incorporated into subsections (b) and (c) but omitted from subsection (f), it fails the first prong of *Chevron*. ...

Had Congress intended a 2-year period of limitations for equitable relief, then of course it could have easily included in subsection (f) what it included in subsections (b) and (c). However, Congress imposed no deadline, yet the Secretary prescribed a period of limitations identical to the limitations Congress imposed under section 6015(b) and (c).

• As a result, the IRS abused its discretion in failing to consider all facts and circumstances in the taxpayer's case. Further proceedings are required to fully determine the taxpayer's liability.

a. **You don't have to actually know the IRS denied § 6015(b) relief for the statute of limitations on seeking review to have expired, but you can always turn to § 6015(f), which for now appears to have an open-ended period for review.** Mannella v. Commissioner, 132 T.C. 196 (4/13/09), *rev'd*, 631 F.3d 115 (3d Cir 1/19/11). The IRS sent the taxpayer a notice of intent to levy and notice of the right to a § 6330 CDP hearing on 6/4/04. On 11/1/06, more than two years later, the taxpayer requested § 6015 relief from joint and several

liability, which the IRS denied on the grounds that the request was untimely. The taxpayer claimed that she did not receive her notice of intent to levy because her former husband received the notices, signed the certified mail receipts, and failed to deliver or inform her of the notices. Judge Haines held that actual receipt of the notice of intent to levy or of the notice of the right to request relief from joint and several liability is not required for the 2-year period in which to request relief under §§ 6015(b) and (c) to begin. The taxpayer's request for relief under §§ 6015(b) and (c) was not timely. However, the taxpayer's claim for relief under § 6015(f), was timely because *Lantz v. Commissioner*, 132 T.C. 131 (4/7/09), held that Reg. § 1.6015-5(b)(1), requiring a request for relief within two years from the IRS's first collection action, is invalid as applied to § 6015(f) relief.

**b. But the IRS will fight this one to the bitter end!** CC-2010-005, Designation for Litigation: Validity of Two-Year Deadline for Section 6015(f) Claims Under Treas. Reg. § 1.6015-5(b)(1) (3/12/10). This Chief Counsel Notice states that because the issue of the validity of the two-year deadline in Reg. § 1.6015-5(b)(1) for filing a claim for § 6015(f) relief, which was held to be an invalid regulation in *Lantz v. Commissioner*, 132 T.C. No. 8 (2009), has been designated for litigation by the Office of Chief Counsel, the IRS will continue to deny claims for relief under § 6015(f) as untimely and will not settle or concede this issue. However, depending on the facts of the case, the merits of the § 6015(f) claim might be conceded.

**c. And the IRS's bitter-end fight to validate the regulation ended up in the Seventh Circuit, where Judge Posner denied the existence of "audible silence."** *Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 6/8/10) (*Lantz II*). The taxpayer was described as "a financially unsophisticated woman whose husband, a dentist, was arrested for Medicare fraud in 2000, convicted and imprisoned. They had been married for only six years when he was arrested and there is no suggestion that she was aware of, let alone complicit in, his fraud." She received a packet that included a notice of a proposed levy on her in 2003, but did not respond because her estranged husband told her "he'd deal with the matter." He asked the IRS to be sent the application form for seeking innocent-spouse relief, explaining that his wife was an "innocent spouse," but he died before filing it. In 2006, the IRS applied taxpayer's \$3,230 income tax refund for 2005 to her joint and several liability for 1999 of more than \$1.3 million. "Unemployed and impecunious, she applied for innocent-spouse relief but the IRS turned her down because she'd missed the two year-deadline ...." The Seventh Circuit (Judge Posner), sustained the regulation and agreed with the IRS's denial of relief, stating, "... any statute of limitations will cut off some, and often a great many, meritorious claims."

• Judge Posner denied the existence of "audible silence" in the following words:

But even if our review of statutory interpretations by the Tax Court were deferential, we would not accept "audible silence" as a reliable guide to congressional meaning. "Audible silence," like Milton's "darkness visible" or the Zen *koan* "the sound of one hand clapping," requires rather than guides interpretation. Lantz's brief translates "audible silence" as "plain language," and adds (mysticism must be catching) that "Congress intended the plain language of the language used in the statute."

• In sustaining the regulation Judge Posner reasoned as follows;

Agencies ... are not bashful about making up their own deadlines[,] ... and because it is as likely that Congress knows this as that it knows that courts like to borrow a statute of limitations when Congress doesn't specify one, the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision"; if there is no deadline in subsection (f), the two-year deadlines in

subsections (b) and (c) will be set largely at naught because the substantive criteria of those sections are virtually the same as those of (f). ...

We must also not overlook the introductory phrase in subsection (f)—“under procedures prescribed by the [Treasury Department]”—or the further delegation in 26 U.S.C. § 6015(h) to the Treasury to “prescribe such regulations as are necessary to carry out the provisions of” section 6015. In related contexts such a delegation has been held to authorize an agency to establish deadlines for applications for discretionary relief.

- The opinion concludes with the hope that the IRS would grant taxpayer relief under § 6343 from its levy on taxpayer by declaring the taxes “currently not collectible” as follows:

Ironically, the Service declared the taxes owed by Lantz’s husband – the crooked dentist – “currently not collectible.” She is entitled *a fortiori* to such relief, and there is no deadline for seeking it. We can at least hope that the IRS knows better than to try to squeeze water out of a stone.<sup>2</sup>

**d. And the Tax Court responds with a big “raspberry” to Judge Posner.** Hall v Commissioner, 135 T.C. 374 (9/22/10). In a reviewed opinion by Judge Goeke, in which seven judges joined, the Tax Court adhered to its position in *Lantz*, supra, that Reg. § 1.6015-5(b)(1) imposing a two-year statute of limitations on claims for relief under § 6015(f) is invalid, notwithstanding the reversal of its decision in *Lantz* by the Seventh Circuit. Five judges dissented.

**e. The Third Circuit likes the way Judge Posner thinks and gives a big “raspberry” to the Tax Court.** Mannella v. Commissioner, 631 F.3d 115 (3d Cir. 1/19/11), rev’g 132 T.C. 196 (4/13/09). In a 2-1 decision written by Judge Greenberg, the Third Circuit reversed the Tax Court and upheld the two-year statute of limitations on taxpayers seeking § 6015(e) equitable relief provided in Reg. § 1.6015-5(b)(1). According to Judge Greenberg’s opinion, “[w]e cannot say that section 6015, in terms, requires that we embrace any particular view of Congress’s intent with respect to a subsection (f) filing deadline,” and “the absence of a statutory filing deadline in subsection (f) similar to those in subsections (b) and (c) does not require us to conclude that the Secretary cannot impose a two-year deadline by regulation.” In the course of applying step one of its *Chevron* analysis, the court stated “[w]e agree with the Court of Appeals for the Seventh Circuit that this silence is not made audible by the presence of deadlines in subsections (b) and (c).” Turning to step two of its *Chevron* analysis, the court acknowledged that the taxpayer’s argument that the legislative history of § 66(c), which provides relief similar to § 6015(e) relief for taxpayers in community property states who do not file a joint return and which was enacted at the same time as § 6015(e), suggested that there should not be a rigid statute of limitations on seeking § 6015(e) equitable relief, “lends some support to [the taxpayer’s] position, but concluded that “it fails to overcome the deference that we must give to Treasury Regulation § 1.6015-5(b)(1) under *Chevron* and it does not clearly demonstrate that Congress intended that requests for relief under subsection 6015(f) not be subject to a two-year filing deadline.” Additionally, the court likewise rejected the taxpayer’s argument that “the inclusion of deadline periods in subsections (b) and (c) but omission of such a period in subsection (f) “demonstrates Congressional intent that requests for equitable relief not be subject to a bright-line time limitation, but rather allow the taxpayer to request relief during the 10-year collection period of 26 U.S.C. § 6502.” However, the Court of Appeals remanded the case to the Tax Court to determine whether the statute of limitations in Reg. § 1.6015-5(b)(1) is subject to equitable tolling and, if so, whether the taxpayer met the standards for equitable tolling.

- Judge Ambro dissented. He agreed with the majority, and disagreed with the Tax Court, on the question of whether Congress had spoken directly on the issue of the time frame in which the taxpayer must seek § 6015(e) relief, but would have invalidated Reg.

---

<sup>2</sup> *But cf.*, Exodus 17:1-7 and Numbers 20:1-13.



§ 1.6015-5(b)(1) in step two of the *Chevron* analysis on the ground that in promulgating the regulation, “the IRS has not advanced any reasoning for its decision to impose a two-year limitations period on taxpayers seeking relief under subsection (f), leaving us no basis to conduct the analysis mandated by *Chevron* step two.” He reasoned that “it is ... a necessary corollary of the deference owed to agencies—that courts may not supplement deficient agency reasoning,” and did not find Judge Posner’s reasoning in *Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 6/8/10), to be convincing.

**f. Stand by your *Lantz*.** *Pullins v. Commissioner*, 136 T.C. No. 20 (5/5/11). The Tax Court (Judge Gustafson) reaffirmed that it would continue to follow its decision in *Lantz v. Commissioner*, 132 T.C. 131 (2009), *rev’d*, 607 F.3d 479 (7th Cir. 2010), that the 2-year deadline for seeking equitable relief from joint and several liability under § 6015(f) imposed by Reg. § 1.6015-5(b)(1) is invalid, notwithstanding the contrary decisions by the U.S. Courts of Appeals for the Seventh Circuit in *Lantz II* and for the Third Circuit in *Mannella v. Commissioner*, 631 F.3d 115, *rev’g*, 132 T.C. 196 (2009). On the facts, relief was granted. Three factors supported denying relief – (1) the taxpayer’s failure to prove economic hardship, (2) her lack of a reasonable expectation that her husband would pay the liabilities when she signed the returns, and (3) her failure to timely file her returns and pay her taxes since the years in issue. Four factors favored granting relief – (1) the taxpayer’s divorce from her husband, (2) his legal obligation pursuant to the divorce decree to pay the tax liabilities, (3) her lack of significant benefit from the nonpayment, and (4) her poor health. A fifth factor, her lack of knowledge of her husband’s unreported income, favored relief as to the deficiency for one particular year. Judge Gustafson found “especially weighty” “the fact that the divorce court – with the family’s circumstances set out before it in greater detail than was possible in our tax case – determined that [the taxpayer’s husband] should pay the taxes, placed proceeds in his hands sufficient to do so, and allocated resources to Ms. Pullins on the assumption that he would do so and she would not have to.”

**g. But *Lantz* doesn’t allow a Mulligan if the tax payer has already litigated denial of relief in another forum.** *Haag v. Commissioner*, T.C. Memo 2011-87 (4/19/11). The taxpayer had sought § 6015 relief in a District Court proceeding in which the government sought to reduce unpaid assessments to judgment, and relief was denied on the ground that her claim was not timely. That decision was affirmed on appeal. In the instant Tax Court proceeding, the taxpayer sought § 6015(f) relief for the same years, claiming that because *Lantz* invalidated the 2-year deadline for seeking equitable relief from joint and several liability under § 6015(f) imposed by Reg. § 1.6015-5(b)(1) changed the law, her claim was not barred. The Tax Court (Judge Gustafson) held that *res judicata* barred the taxpayer’s claim; her claim for relief was an issue in the prior litigation, even though the merits were not reached, and she meaningfully participated. “[A] change in the law after a matter has been litigated does not change the claim-preclusive effect of the earlier decision.”

**h. Another taxpayer loss.** *Jones v. Commissioner*, 642 F.3d 459 (4th Cir. 6/13/11). Holds that Reg. § 1.6015-5(b)(1), which mandates a two-year limitations period for persons seeking equitable innocent spouse relief under § 6015(f), is valid. Judge Niemeyer used a *Chevron* analysis to follow the Seventh and Third Circuit precedents in *Lantz II* and *Mannella*.

**i. And the IRS demonstrates that it has a heart by throwing in the towel even though it was consistently winning in the Courts of Appeals.** Notice 2011-70, 2011-32 I.R.B. 135 (7/25/11). The IRS announced that it will no longer enforce Reg. § 1.6015-5(b)(1) limiting to two years after the date of the IRS’s first collection activity the period in which it would consider requests for equitable relief under § 6015(f). Under the new procedures, the IRS will consider requests for relief under § 6015(f) as long as the period of limitation on collection of taxes provided by § 6502 remains open for the tax years at issue, and if the relief sought involves a refund of tax, the period of limitation on credits or refunds provided in § 6511 will govern whether the IRS will consider the request for relief for purposes of determining whether a credit or refund may be available. The relief from the truncated period of limitations is retroactive. For requests for § 6015(f) that have already been submitted and are under

consideration, the IRS will consider the request for equitable relief even if the request was submitted more than two years after the first collection activity was taken if the applicable period of limitation under § 6502 or § 6511 was open when the request for equitable relief was filed. Individuals whose requests for equitable relief under § 6015(f) were denied by the IRS solely for untimeliness and were not litigated may reapply for § 6015(f) relief, and the original Form 8857 will be treated as a claim for refund for purposes of the period of limitation on refunds. For case in litigation, the IRS will concede the timeliness issue consistent with the position announced in the notice. For cases that were litigated and in which (1) the validity of the two-year deadline to request equitable relief was at issue, (2) the decision in the case is final, and (3) the IRS stipulated in the court proceeding that the individual's request for equitable relief would have been granted if the request had been timely, the IRS will not seek to collect from the individual any portion of the underlying liability for which equitable relief would have been granted.

#### **H. Miscellaneous**

**1. Congress discovers that corporations as well as unincorporated businesses might cheat less if payors rat them out to the IRS.** The 2010 Health Care Act amended § 6041 to extend to payments to corporations the information reporting requirement for all payments by a business to any single payee (other than a payee that is a tax exempt corporation) aggregating \$600 or more in a calendar year for amounts paid in consideration for property or services. However, the expanded rule does not override other specific Code provisions that exempt payments from reporting, for example, securities or broker transactions as defined under § 6045(a) and the regulations thereunder. The new rule is effective for payments made after 12/31/11.

**a. This provision was repealed one year later, before it went into effect.** On 4/14/11, President Obama signed legislation to repeal the burdensome 1099 reporting requirements enacted under health care legislation [PPACA].

**2. IRS releases recommendations that paid tax return preparers would be required to register.** IR-2010-1, 2010 TNT 2-1 (1/4/10). The IRS released a list of recommendations that would require that individuals who sign a tax return as a paid preparer pay a user fee to register online with the IRS and obtain a preparer tax identification number [PTIN]. All preparers – except attorneys, CPAs and enrolled agents – would have to pass competency exams and complete 15 hours of annual CPE in federal tax law topics. The IRS proposes to expand Circular 230 to cover all signing and nonsigning return preparers. Registered preparers would be listed on a publicly-searchable data base and would be required to have PTINs in 2011.

**a. We wish we had Karen's confidence in Accenture. The IRS Office of Professional Responsibility is not at all concerned with the task of registering paid tax preparers. That is because Accenture will be the vendor to establish a system for on-line registration, with a target date of 9/1/10. Accenture will undoubtedly bring to this task the same thoughtful foresight and judgment it used when it selected Tiger Woods as its leading spokesperson.** 2010 TNT 85-24 (5/4/10). The IRS announced that Accenture National Security Services, LLC, will be the vendor to establish a system for on-line registration of paid tax return preparers. "The vendor will develop and maintain the registration application system and address related questions." Karen Hawkins, Director of the IRS Office of Professional Responsibility recently stated that she was not worried about registration of paid preparers because Accenture would take care of it completely.

**b. Some of us learned about the concept of "fee simple" in school but these will not be "simple fees"; instead there will be multiple fees – some of which will be raked off by Accenture.** REG-139343-08, User Fees Relating to Enrollment and Preparer Tax Identification Numbers, 75 F.R. 43110 (7/23/10). Registration for an identifying number, together with a \$50 fee will be required for all tax return preparers who prepare all, or substantially all, of a return or claim for refund of tax after 12/31/10. Accenture may charge a "reasonable fee" that is independent of the \$50 user fee.

• The IRS later confirmed that the user fee for the first year of registration will be \$64.25; the excess \$14.25 will permit Accenture to "wet its beak."

c. The IRS issued proposed regulations which would regulate tax return preparers, and establish a new class of practitioner – a “registered tax return preparer” – whose qualifications obviously exceed those of any other class of practitioner. REG-138637-07, Regulations Governing Practice Before the Internal Revenue Service, 75 F.R. 51713 (8/19/10). These proposed regulations would amend Circular 230 to apply to all paid return preparers and identify exactly which preparers have a registration obligation. They would also change the general Circular standard of contact from “more likely than not” to “reasonable basis” [sic].

Specifically, the proposed regulations establish “registered tax return preparers,” as a new class of practitioners. Sections 10.3 through 10.6 of the proposed regulations describe the process for becoming a registered tax return preparer and the limitations on a registered tax return preparer’s practice before the IRS. In general, practice by registered tax return preparers is limited to preparing tax returns, claims for refund, and other documents for submission to the IRS. A registered tax return preparer may prepare all or substantially all of a tax return or claim for refund, and sign a tax return or claim for refund, commensurate with the registered tax return preparer’s level of competence as demonstrated by written examination. The proposed regulations also revise section 10.30 regarding solicitation, section 10.36 regarding procedures to ensure compliance, and section 10.51 regarding incompetence and disreputable conduct.

Proposed regulations under section 6109 of the Code (REG-134235-08) published in the Federal Register (75 FR 14539) on March 26, 2010, also implement certain recommendations in the Report. The proposed regulations under section 6109 provide that, for returns or claims for refund filed after December 31, 2010, the identifying number of a tax return preparer is the individual’s preparer tax identification number (PTIN) or such other number prescribed by the IRS in forms, instructions, or other appropriate guidance. The proposed regulations under section 6109 provide that the IRS is authorized to require through other guidance (as well as in forms and instructions) that tax return preparers apply for a PTIN or other prescribed identifying number, the regular renewal of PTINs or other prescribed identifying number, and the payment of user fees.

• Just as “registered” mail is “better” than “certified” mail, a “registered tax return preparer” – whose duties focus solely on the preparation of tax returns – seems to be “better” than a “certified public accountant” – whose duties are numerous and varied. Additionally, the “registered” practitioner gets his authority from the U.S. Government’s Internal Revenue Service while the “certified” practitioner gets his authority merely from one of the states.

d. **Proposed amendments to Circular 230.** REG-138637-07, Rules Governing Practice Before the Internal Revenue Service, 2010-44 I.R.B. 581 (8/19/10). These proposed regulations contain standards with respect to tax returns under § 10.34, as well as new rules governing the oversight of tax return preparers under §§ 10.3 through 10.6. There are also proposed revisions to § 10.30 regarding solicitation, § 10.36 regarding procedures to ensure compliance, and § 10.51 regarding incompetence and disreputable conduct.

e. **Final § 6109 regulations.** T.D. 9501, Furnishing Identifying Number of Tax Return Preparer, 75 F.R. 60309 (9/28/10). Final regulations amending § 1.6109-2 explaining how the IRS will define those required to obtain a PTIN as a return preparer, with four examples.

f. **David Williams is to be given “broad responsibility.”** IR-2010-107 (10/26/10). In a speech to the AICPA Fall Meeting, IRS Commissioner Shulman announced the creation of a Return Preparer Office under David R. Williams at the IRS itself, which office is to have “broad responsibility” for the return preparer initiative. The office will complement the work of the IRS Office of Professional Responsibility under Karen Hawkins.

g. **Register those staff members as “supervised preparers”!** Notice 2011-6, 2011-3 I.R.B. 315 (12/30/10). This notice provides guidance on the new

regulations § 1.6901-2 governing tax return preparers, including the exemption from continuing education requirements and competency exams for non-signing supervised staff members employed and supervised by an attorney, CPA or enrolled agent; however, these “supervised preparers” must obtain PTINs and pass the mandatory tax compliance and suitability checks [and pay the \$64.25 annual fee]. The notice also contains a list of forms that do not require that their preparer have a PTIN, as well as interim rules that permit individuals to obtain provisional PTINs before the first offering of competency examinations, which PTINs may be renewed until the end of 2013.

**h. Relief for IRS delays.** Notice 2011-11, 2011-7 I.R.B. 497 (1/26/11). This notice temporarily allows certain tax return preparers who have made a good faith effort to obtain a PTIN to prepare tax returns for compensation even though they have not received a PTIN. Any tax return preparer who receives (1) a notice from the IRS that it was unable to process his online PTIN application or (2) an acknowledgment of receipt of the paper PTIN application will be allowed to prepare and file tax returns or claims for refund for compensation after the tax return preparer complies with all instructions provided in the notification or acknowledgment letter. This relief applies only for the 2011 tax return filing season.

**i. Final amendments to Circular 230.** T.D. 9527, Rules Governing Practice Before the Internal Revenue Service, 76 F.R. 32286 (5/31/11). These regulations adopt, with some changes, proposed regulations (REG-138637-07), see d., above. Attorneys and CPAs are not affected by the amendments to Circular 230 §§ 10.3, 10.4, 10.5, 10.7 and 10.9, which relate to rules regarding registered tax return preparers. Section 10.30(a) (regarding advertising and solicitation restrictions) provides: “An example of an acceptable description for registered tax return preparers is ‘designated as a registered tax return preparer by the Internal Revenue Service.’”

- **Section 10.34 standards for signing tax returns as preparer.** With respect to the standards for tax returns and documents, etc., § 10.34(a)(1)(i) provides that a practitioner may not willfully, recklessly, or through gross incompetence, sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that: (A) lacks a reasonable basis; (B) is an unreasonable position as described in section 6694(a)(2) (including the related regulations and other published guidance); or (C) is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) (including the related regulations and other published guidance).

- **Section 10.36 standards for supervisory responsibility.** There is supervisory responsibility under § 10.36(b) for overseeing a firm’s practice of preparing tax returns, claims for refunds and other documents filed with the IRS must take reasonable steps to ensure that the firm has adequate procedures in effect for purposes of complying with Circular 230.

- It appears that references to the Office of Professional Responsibility were present in the proposed regulations and missing from the final regulations. Query: Does this mean that attorneys, CPAs and Enrolled Agents would be subject to discipline from the IRS Return Preparer Office, and not from the OPR, for improprieties in connection with the preparation of returns?

- These regulations will become effective on 8/2/11.

**j. There are no registered tax return preparers – yet.** Notice 2011-45, 2011-25 I.R.B. 886 (5/31/11). Because the conditions for becoming a registered tax return preparer are not yet able to be satisfied by any individual – neither the competency examination nor the suitability check are not yet available – no individual may represent that he is a registered tax return preparer. In addition, Circular 230 § 10.30 will be amended to require that any individual who represents himself or herself to be a registered tax return preparer in any paid advertising must include the following statement: “The IRS does not endorse any particular individual tax return preparer. For more information on tax return preparers go to IRS.gov.”

**k. It is only a rumor that the IRS Return Preparer Office has put out an RFP for DNA matching services.** REG-116284-11, User Fees Relating to the Registered

Tax Return Preparer Competency Examination and Fingerprinting Participants in the Preparer Tax Identification Number, Acceptance Agent, and Authorized E-File Provider Programs, 76 F.R. 59329 (9/26/11). These proposed regulations would set fees going to the IRS of (1) \$27 for taking the registered tax return preparer competency examination testing and (2) \$33 for being fingerprinted. These fees are in addition to the unspecified fees that will be paid to the private vendors that administer the examinations and take fingerprints.

1. Notice 2011-80, 2011-43 I.R.B. \_\_\_ (9/21/11). This notice provides guidance for the issuance of provisional PTINs and their annual renewal on a calendar year basis. It also states that the IRS will not require individuals to be fingerprinted prior to obtaining a PTIN until at least 4/18/12. Attorneys, CPAs, enrolled agents, enrolled retirement plan agents and enrolled actuaries will not be required to be fingerprinted "at this time."

m. REG-140280-09, Tax Return Preparer Penalties Under Section 6695, 76 F.R. 62689 (10/11/11). Proposed regulations under § 6695(g), Prop. Reg. § 1.6695-2, relating to tax return preparer due diligence requirements for determining under earned income credit eligibility. When made final, the regulations will require the completion and submission of Form 8867 with each tax return or claim for refund claiming the EIC.

3. **This whistleblower gets a chance to let the Tax Court decide whether or not he was whistling in the dark.** Cooper v. Commissioner, 135 T.C. 70 (7/8/10). The Tax Court (Judge Kroupa) held that it has jurisdiction under § 7623(b)(4) to review the denial of a claim for a whistleblower award. The court rejected IRS's argument that the Tax Court's jurisdiction is limited to appeals of a determination of the amount of the award.

a. **The whistleblower was whistling in the dark.** Cooper v. Commissioner, 136 T.C. No. 30 (6/20/11). Cooper had provided information to the IRS regarding an alleged underpayment of tax and sought a whistleblower award. The IRS determined not to pursue the matter and denied any award. Cooper sought review in the Tax Court. In an earlier proceeding, Cooper v. Commissioner, 135 T.C. No. 4 (2010), the Tax court determined that it had jurisdiction to review a denial of any award. In the instant case, the Tax Court (Judge Kroupa) held that § 7623(b) does not confer on the Tax Court jurisdiction to redetermine the tax liability of the taxpayer with respect to whom a claimant is seeking a whistleblower reward.

- The Senate Finance Committee's version of § 7623 would have permitted the whistleblower's lawyer to participate in the audit of the taxpayer.

b. **Was the whistleblower whistling in the dark?** Kasper v. Commissioner, 137 T.C. No.4 (7/12/11). In an opinion by Judge Haines, the Tax Court reaffirmed its earlier holding in Cooper v. Commissioner, 136 T.C. No. 30 (2011), that a letter from the IRS rejecting a whistleblower claim constitutes a determination, for which review may be sought in the Tax Court. The court further held that the 30-day period for seeking review commences upon mailing or personal delivery of the letter, and that the IRS must demonstrate either mailing or delivery to the whistleblower's last known address.

4. **How much is that little tax cheat in the window?** REG-131151-10, 76 F.R. 2852 (1/18/11), Rewards and Awards for Information Relating to Violations of Internal Revenue Laws. The Treasury has published proposed amendments to Reg. § 301.7623-1 that clarify the definitions of proceeds of amounts collected and collected proceeds for purposes of § 7623.

a. **Large whistleblower award announced.** An attorney, Egan Young of Egan Young Attorneys at Law in Blue Bell, PA – not to be confused with Blue Ball, PA, see Ginzburg v. United States, 383 U.S. 463, 467 (1966) – claimed that one of his clients, a CPA, was awarded more than \$4.5 million for alerting the IRS of a Fortune 500 financial services company's \$20 million unreported tax liability. 2011 TNT 69-4 (4/11/11).

- Query whether a CPA is subject to professional discipline if he reports a client to the IRS?

5. **"Sorry, you can't cite the other guy's PLR to support your argument," but this case involved rulings with respect to the same liability issued to the**

seller which the buyer attempted to use.<sup>3</sup> AmerGen Energy Co., LLC v. United States, 94 Fed. Cl. 413 (9/1/10). The Court of Federal Claims (Judge Bush) held that private letter rulings issued to the seller of a business relating to the treatment of certain operating expenditures were not precedential or relevant evidence in buyer's case regarding the same issue. The IRS was not bound by the private letter rulings.

• The rulings issued to the seller purportedly concluded that the nuclear decommissioning liabilities were "fixed and reasonably determinable." The buyer attempted to use the *IBM* case. Judge Bush stated:

The court notes that plaintiff relies extensively on *Int'l Bus. Machs. Corp. v. United States*, 343 F.2d 914, 170 Ct. Cl. 357 (Ct. Cl. 1965) (*IBM*), a case with thirty negative citing references on Westlaw, and omits any reference to the precedential limitation of the holding of that case to its facts. See, e.g., *Fla. Power & Light Co. v. United States*, 375 F.3d 1119, 1124 (Fed. Cir. 2004) ("We need not decide whether the appellant would be entitled to relief under *IBM*, however, because the decision in *IBM* was effectively limited to its facts by subsequent decisions of the Court of Claims . . .") (citations and footnote omitted). Plaintiff perhaps believes that this case falls within the fact pattern of *IBM*. Nonetheless, plaintiff should have alerted the court to the binding precedent limiting the scope of the holding of *IBM*, so that the weight to be accorded *IBM* was clear. See, e.g., *Jewelpak Corp. v. United States*, 297 F.3d 1326, 1333 n.6 (Fed. Cir. 2002) (stating that "officers of our court have an unfailing duty to bring to our attention the most relevant precedent that bears on the case at hand—both good and bad—of which they are aware") (citations omitted). Plaintiff could not have been unaware of this binding precedent, because another case upon which plaintiff greatly relies discussed, at length, the limits placed on the holding of *IBM*. See *Vons Cos. v. United States*, 51 Fed. Cl. 1, 10 & nn. 9-10 (2001), modified in part by *Vons Cos. v. United States*, No. 00-234T, 2001 U.S. Claims LEXIS 241, 2001 WL 1555306 (Fed. Cl. Nov. 30, 2001).

The court, in the context of this discovery dispute over PLRs, need not reach the issue of whether plaintiff, as a purchaser of nuclear power plants, is "similarly-situated" to sellers of nuclear power plants, in regards to the tax treatment of assumed decommissioning liability.

6. **Another court tells the IRS it can't pretend it doesn't know it has the wrong address for the taxpayer.** Terrell v. Commissioner, 625 F.3d 254 (5th Cir. 11/1/10). The Tax Court dismissed the taxpayer's petition for innocent spouse relief because she failed to file within 90 days from the date IRS first mailed its determination not to grant relief, had been mailed to the same address shown on prior tax returns that the IRS had used for multiple prior mailings that had been returned as undeliverable by the USPS. However, the taxpayer timely filed petition within 90 days of date IRS re-sent the notice of determination to the new address on her tax return filed between the date the most recent earlier notice of determination had been mailed and the date it had been returned as undeliverable. Reg. § 1.6212-2 provides that a taxpayer's last known address as the address that appears on the taxpayer's most recently filed and properly processed federal tax return, unless the taxpayer has given the IRS clear and concise notification of a different address. The Fifth Circuit reversed the Tax Court's decision and remanded the case. The court (Judge Prado) held that even if the IRS has not received "clear and concise notification" of the taxpayer's change of address, "the IRS must use 'reasonable diligence' to determine the taxpayer's address in light of all relevant circumstances." If the IRS knows or should have known know at the time of mailing a notice that the taxpayer's address on file might no longer be valid, "reasonable diligence" requires further investigation. The IRS may not rely on a lack of notification once it is on notice that its address on file is incorrect. Because three separate prior mailings to taxpayer's address on file with IRS had been returned as

<sup>3</sup> The rulings were ten years old. ". . . but that was in another country, And besides, the wench is dead." Eliot (quoting Jonson).

undeliverable, the IRS should have known that taxpayer's address on the earlier filed tax return was incorrect.

7. **Soon there will no paper trail for anything, but digital trails might be even longer.** T.D. 9507, Electronic Funds Transfer of Depository Taxes, 75 F.R.75897 (12/2/10). The Treasury and IRS have promulgated regulations (Reg. §§ 1.1461-1; 1.6302-1; 1.6302-2; 1.6302-3; 1.6302-4; 31.6071(a)-1; 31.6302-1; 31.6302(c)-3; and 301.6302-1) requiring all federal tax depositors to use electronic funds transfers for all federal tax deposits. The rules regarding federal tax deposit coupons have been eliminated.

8. **Just because there are no longer any District Directors doesn't mean the IRS can't fulfill functions that the regulations still assign to District Directors.** Grunsted v. Commissioner, 136 T.C. No. 21 (5/11/11). The taxpayer, against whom frivolous return penalties had been assessed, argued that because Reg. § 301.6203-1 provides for assessment officers to be appointed by district directors, and there are no longer any district directors, therefore no assessment officers have been properly appointed and thus frivolous return penalties could not be validly assessed against him. The Tax Court was unimpressed by this argument. Judge Kroupa held that provisions of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685, which required the IRS to substantially modify its regional and district organization, keeps in effect regulations that refer to officers whose positions no longer exist, e.g., District Directors. The Act also provides that nothing in the reorganization plan impair any right or remedy of the IRS to recover any penalty claimed to have been collected without authority.

9. T.D. 9531, Extension of Time for Filing Returns, 76 F.R. 36996 (6/24/11). Final regulations §§ 1.6081-2 and 1.6081-6 provide for an automatic five-month extension of time to file returns for partnerships, estates and trusts. The IRS rejected extending the extension to six-months because of hardships in completing returns that would be created for individual taxpayers with six-month extension. Reg. § 1.6081-2(a)(2) allows a six-month automatic extension for electing large partnerships, which are required by § 6031(b) to provide K-1s to beneficial interest holders by March 15 in any event.

10. **The burden is shifted to the IRS only if you cooperate.** McNeill v. Commissioner, T.C. Memo. 2011-150 (6/28/11). If the taxpayer asserts a reasonable dispute with any item shown on an information return on which a proposed deficiency is based, and the taxpayer has fully cooperated with the IRS with respect to the production of witnesses, documents, and other information, § 6201(d) requires the IRS to produce additional reasonable and probative evidence of the deficiency. In this case, in which the taxpayer filed a "zero" return and did not cooperate with the IRS, Judge Laro held that § 6201(d) did not apply. The IRS could rely on information returns and the burden of proof remained on the taxpayer.)

## **XI. WITHHOLDING AND EXCISE TAXES**

### **A. Employment Taxes**

1. **Wisdom from the Mount. Medical residents may be students for FICA taxes.** United States v. Mount Sinai Medical Center of Florida, Inc., 486 F.3d 1248 (11th Cir. 5/18/07). Section 3121(b)(10) provides that employment taxes are not payable with respect to services performed in the employ of a college or university by a student who is enrolled and regularly attending classes. The government argued that legislative history with respect to the repeal of an exemption for medical interns in 1965 (former § 3121(b)(13)) established as a matter of law that medical residents are subject to employment taxes. The Eleventh Circuit concluded that § 3121(b)(10) is unambiguous in its application to students and that the statute requires a factual determination whether the hospital is a "school, college, or university" and whether the residents are "students."

a. **This is no April fool. The Minnesota District Court also finds that medical residents at the University of Minnesota are students.** Regents of the University of Minnesota v. United States, 101 A.F.T.R.2d 2008-1532 (D. Minn. 4/1/08). The university's summary judgment motion was granted by the District Court, which held that medical residents at the University of Minnesota are not subject to employment taxes under the student exclusion

of § 3121(b)(10). The court reiterated its conclusion that the full-time employee exception in Reg. § 31.3121(b)(10)-2(d), as amended in 2004, is invalid.

**b. The District Court finds that the Mount Sinai Medical Center is a school and the residents are students.** United States v. Mount Sinai Medical Center of Florida, Inc., 102 A.F.T.R.2d 2008-5373 (S.D. Fla. 7/28/08). After the decision in *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), Mount Sinai Medical Center obtained refunds for FICA taxes paid in 1996-1997. The United States filed suit against the Medical Center for erroneous refunds. Following the Eleventh Circuit's direction to make a factual determination whether the program qualifies for the § 3101(b)(10) exception, the District Court found that the Medical Center's residency programs were operated as a "school, college, or university," that residents were present for training in patient care, which was an intrinsic and mandatory component of the training, and that the residents were "students" who were regularly enrolled and attending classes. The court also found that the students' performance of patient care services was incident to their course of study.

**c. South Dakota medical residents are also students.** Center for Family Medicine v. United States, 102 A.F.T.R.2d 2008-5623 (D. S.D. 8/6/08). Following *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998); the South Dakota District Court held that medical residents in the Center for Family Medicine (CFM) and University of South Dakota School of Medicine Residency Program (USDSMRP) were eligible for the student exception to the definition of employment under § 3101(b)(10). The court rejected the government's assertion that CFM was not a school, college or university because CFM was affiliated with a non-profit hospital. The court found that CFM's work includes teaching its medical residents the skills required to practice in their chosen profession. The court also concluded that the students were "enrolled" in the institution and that their attendance at noon conferences and medical rounds established that the students regularly attended classes. Tossing a small bone to the government, the court held that chief residents in the programs, who are essentially coordinators for the residency programs, were not students.

**d. Residents in Chicago are also students.** University of Chicago Hospitals v. United States, 545 F.3d 564 (7th Cir. 9/23/08). The court affirmed the District Court's denial of the government's motion for summary judgment based on the government argument that medical residents are *per se* ineligible for the student exemption from employment taxes under § 3121(b)(10). The court indicates that a case-by-case analysis is required to determine whether medical residents qualify for the statutory exemption.

**e. And ditto for medical residents in Detroit.** United States v. Detroit Medical Center, 557 F.3d 412 (6th Cir. 2/26/09). Reversing the District Court's summary judgment, the Sixth Circuit joins the lineup holding that medical residents at the seven Detroit area hospitals operated by the Detroit Medical Center in a joint program with Wayne State University, which provides graduate medical education, may be students entitled to exemption from employment taxes under § 3121(b)(10). The court remanded the case for further development of the record regarding the nature of the residents' relationship to the hospitals and the education program. The court indicated that further development of the record would not preclude deciding the matter on summary judgment. The Sixth Circuit also affirmed summary judgment that the stipends paid to medical residents were not scholarships or fellowships excludible from income under § 117. The court found both that the stipends were received in exchange for services and that the medical residents were not candidates for a degree as required for exclusion under the terms of § 117.

**f. And ditto again for Sloan-Kettering.** United States v. Memorial Sloan-Kettering Cancer Center, 563 F.3d 19 (2d Cir. 3/25/09). Following similar decisions in the Sixth, Seventh, Eighth, and Eleventh Circuits, the Second Circuit Court of Appeal reversed summary judgment for the United States holding that the District Courts for the Northern and Southern Districts of New York erred in holding as a matter of law that medical residents at the Albany Medical Center and the hospitals of the Memorial Sloan-Kettering Cancer Center were not eligible for exclusion from employment taxes under § 3121(b)(10). The cases were remanded



to the trial courts for factual determinations whether the residents were students and whether the hospitals were schools.

g. **But the tide turns against the Mayo Clinic; however, the Supreme Court granted certiorari to the Eighth Circuit. Mayo Clinic residents may or may not be students, the Supreme Court will decide.** Mayo Foundation for Medical Education and Research v. United States, 568 F.3d 675 (8th Cir. 6/12/09), *cert. granted*, 130 S. Ct. 3353 (6/10/10). For purposes of the student exclusion from FICA taxes under § 3121(b)(10), Reg. § 31.3121(b)(10)-2(c) and (d), limit the definition of a school, college, or university to entities whose “primary function is the presentation of formal instruction.” Reg. § 31.3121(b)(10)-2(d) provides that to qualify as a “student” rather than be classified as an employee, any services rendered must be “incident to and for the purpose of pursuing a course of study” at the institution for which the student provides the services. Furthermore, under the regulation, a person whose work schedule is 40 hours or more per week is a full-time employee rather than a student. The District Court, in granting refunds of employment taxes, declared the regulation invalid. Applying the deference standard of *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Eighth Circuit reversed and remanded the case for entry of judgment for the United States. The court concluded that application of the exemption only to students pursuing a course of study who are not full time employees is a reasonable interpretation of the statute. The court declined to consider whether the portion of the regulation limiting the definition of a school or college is valid because the medical residents were not students under the regulation in any event.

h. **The Supremes spread Mayo all over the Code. National Muffler is dead: long live Chevron.** Mayo Foundation for Medical Education and Research v. United States, 131 S. Ct. 704 (1/11/11). In a unanimous decision, written by Chief Justice Roberts, the Supreme Court affirmed the Court of Appeals in what undoubtedly will be one of the most far reaching tax decisions ever rendered by the Court. The Court applied the two part test of *Chevron, U.S.A., Inc. v. Natural Resources. Defense Council, Inc.*, 467 U.S. 837 (1984), to test the validity of the regulation and upheld it. Under *Chevron*, the first question is whether Congress has directly spoken to the precise question at issue. If the statute has “directly addressed the precise question at issue” the regulation must follow the unambiguously expressed intent of Congress. If the statute is silent or ambiguous with respect to the specific issue, the second question is whether the agency’s answer is based on a permissible construction of the statute. In this second step, according to the Supreme Court, a court “may not disturb an agency rule unless it is ‘arbitrary or capricious in substance, or manifestly contrary to the statute.’” Thus, a court may not substitute its own construction for the reasonable interpretation of an agency. In *Mayo*, the Supreme Court held that “[t]he principles underlying our decision in *Chevron* apply with full force in the tax context.” In applying *Chevron*, the Court unambiguously overruled its prior decision in *National Muffler Dealers Association v. United States*, 440 US 472, 477 (1979), rendering the *National Muffler* standards irrelevant in all future cases. Under *National Muffler* the inquiry was as follows:

In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner’s interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

• In overruling *National Muffler*, the Court unequivocally stated that “an agency’s interpretation of an ambiguous statute does not turn on such considerations.” The Court specifically stated that “[a]gency inconsistency is not a basis for

declining to analyze the agency's interpretation under the *Chevron* framework." Quoting its earlier decision in *Bob Jones University v. United States*, 461 U.S. 574, 596 (1983), the Court stated, "[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems." The Court also rejected the taxpayer's argument that a regulation, like the one question, promulgated under the general authority of § 7805(a) was entitled to less deference than one "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision," and in so doing overruled its prior decisions in *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981), and *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982), which had so held, stating that the court's inquiry does not turn on whether Congress's delegation of authority was general or specific. Furthermore, the Court held that "it is immaterial to our analysis that a 'regulation was prompted by litigation,'" noting that in *United Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001), it had "expressly invited the Treasury Department to 'amend its regulations' if troubled by the consequences of our resolution of the case." Thus, the Supreme Court has unambiguously stated that as long as a regulation can withstand *Chevron* analysis, a Treasury Regulation can reverse case law. Finally, however, in upholding the validity of the regulation, the Court emphasized that the regulation was promulgated after notice and comment, thus leaving open the possibility that *Mayo/Chevron* deference might not apply to a Temporary Regulation issued without notice and comment.

i. **And the IRS throws in the towel on refund claims for FICA taxes paid before April Fools' Day, 2005.** I.R. 2010-25 (3/2/10). The IRS has decided to accept the position that medical residents are exempt from FICA taxes under the student exception and will issue refunds to hospitals, universities, and medical residents who have filed claims for refunds of FICA taxes paid before 4/1/05, which is the effective date of amendments to Reg. § 31.3121(b)(10)-2 providing that employees who work 40 hours or more during a week are not eligible for the student exception.

2. **S corporation "John Edwards gambit" dividends may be treated as wages.** *David E. Watson, P.C. v. United States*, 714 F. Supp. 2d 954 (S.D. Iowa 5/27/10). Using a common tax reduction device, David Watson formed an S corporation that was a member of Watson's accounting firm. The S corporation contracted with the accounting firm to provide services. Watson was paid a salary of \$24,000 as an employee of the S corporation, on which the S corporation paid employment taxes. The remainder of the S corporation income, approximately \$200,000 per year, was distributed to Watson as a dividend, not subject to employee taxes. The IRS recharacterized the dividends as wages. The S corporation paid an assessment and brought a refund action. In a motion for summary judgment the S corporation asserted that its intent controls whether amounts paid are wages and that it intended to pay dividends in the amount of cash on hand after the payment of wages. Citing a long line of authorities in support of its position, the District Court held that the S corporation's "self proclaimed intent" to pay salary does not limit the government's ability to recharacterize dividends as wages. The court indicated that whether amounts paid to Watson were remuneration for services is a question of fact.

• The court's opinion concluded with the following passage:

In support of its Motion for Summary Judgment, Plaintiff points the Court to the following oft-cited statement of Judge Learned Hand:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

See Pl.'s Reply Br. at 5 n. 2 (quoting *Commissioner of Internal Revenue v. Newman*, 159 F.2d 848, 850-51 (2d Cir.1947) (L. Hand, J., dissenting)). While the Court agrees fully with Judge Learned Hand, it would remind Plaintiff of Justice Oliver Wendell Holmes' succinct, yet equally eloquent statement in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*: "Taxes are

what we pay for civilized society.” 275 U.S. 87, 100 (1927) (Holmes, J., dissenting). Indeed, “the greatness of our nation is in no small part due to the willingness of our citizens to honestly and fairly participate in our tax collection system.” *Manley v. Commissioner of Internal Revenue*, T.C. Memo 1983-558 (Sept. 12, 1983). Thus, while Plaintiff is free to structure its financial affairs in such a way as to avoid paying “more [taxes] than the law demands,” Plaintiff is not free to structure its financial affairs in a way that avoids paying those taxes demanded by the law. In this case, the law demands that Plaintiff pay employment taxes on “all remuneration for employment,” and there is clearly a genuine issue of material fact as to whether the funds paid to Watson, in actuality, qualify as such.

a. **Since the judge gave the IRS everything it asked for, will the IRS go for the whole kit and caboodle the next time?** *David E. Watson, P.C. v. United States*, 757 F. Supp. 2d 877 (S.D. Iowa 12/23/10). On the merits, Judge Pratt rejected the taxpayer’s claim that the wages subject to employment tax were limited to the \$24,000 salary formally paid to the sole shareholder/sole employee. In addition to the “salary” in each of the years in question, the corporation distributed approximately \$175,000 of “profits,” pursuant to a corporate resolution authorizing “payment to Watson of ‘dividends in the amount of available cash on hand after payment of compensation and other expenses of the corporation.’” Citing *Joseph Radtke, S.C. v. United States*, 712 F. Supp. 2d 143 (E.D. Wis. 1989), *Spicer Accounting, Inc. v. United States*, 918 F.3d 90 (9th Cir. 1990), and *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), as particularly persuasive, the court concluded that “‘characterization of funds disbursed by an S corporation to its employees or shareholders turns on an analysis of whether the payments at issue were made ... as remuneration for services performed.’” After examining the facts, the court concluded that the reasonable amount of Watson’s compensation for each of the years at issue was \$91,044, increasing the \$24,000 salary amount by the full amount of the \$67,044 that the corporation claimed was a § 1368 distribution, thus upholding in full the government’s position.

3. **Independence massages away employment taxes.** *Mayfield Therapy Center v. Commissioner*, T.C. Memo. 2010-239 (10/28/10). The taxpayer rented booth space to massage therapists, cosmetologists and nail technicians for \$80 base rent or 25 percent of the service provider’s gross revenue. The service providers set their own hours, their appointments were made by a receptionist at taxpayer’s facility, they were free to charge prices that differed from posted prices, they provided their own supplies, and in some cases they individually decorated their own space, but occasionally shared space. Each provider was a separately licensed professional. Payments were collected centrally and divided in accord with the amount paid by each provider’s individual client. Applying the 20 factors of Rev. Rul. 87-41, 1987-1 C.B. 296 (which one of us had a hand in drafting as a Professor-in-Residence in the Office of Chief Council), the court (Judge Thornton) concluded that – although the financial arrangement represented payment by the taxpayer to the service providers – the weekly rent arrangement and compensation to the service providers on a commission basis with no guaranteed return favored independent contractor status. The court also pointed to the fact that the workers provided their own expenses, bore the risk of losses, that they could increase their income by working longer hours, and were not directed in providing services to clients as supporting independent contractor status. While indicating that the case was close, the court decided that factors indicating the service provider’s autonomy predominate over factors indicating the taxpayer’s control and concluded that the service providers were independent contractors for whom the taxpayer was not liable for employment taxes.

4. **Social Security is cheaper for 2011, but the deficits grow.** The Compromise Tax Relief Act of 2010, § 601, reduces the employee portion of the Old-Age, Survivors, And Disability Insurance Tax (OASDI) from 6.2% to 4.2% for calendar year 2011.

- The 4.2% rate also applies to the railroad retirement tax.

5. **Tax law firm misses on its own special allocation.** Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. No. 7 (2/9/11). The taxpayer law firm practiced tax law in a Kansas limited liability partnership. The partnership consisted of the three lawyers in the firm plus a subchapter S corporation wholly owned by an ESOP whose beneficiaries were the three attorney partners. The court (Judge Jacobs) held that the individual partners' share of partnership income was subject to self-employment tax. The court also rejected the partnership's argument that the partners of the limited liability partnership were limited partners subject to the § 1402(a)(13) exclusion from self-employment tax the income of a limited partner. The court opined that the purpose of § 1402(a)(13) "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage." The court concluded that legislative history did not support a holding that the exclusion applied to partners who performed services for the partnership in their capacity as partners. Thus, the court held that distributive shares arising from legal services performed in the partners' capacity as partners in the law firm were subject to self-employment tax.

6. **Attorneys are employees of their professional corporation law firm.** Donald G. Cave A Prof. Law Corp. v. Commissioner, T.C. Memo 2011-48 (2/28/11) The court (Judge Marvel) held that Donald Cave, the principal attorney for the taxpayer S corporation engaged in law practice, associates of the firm, and a law clerk were employees for employment tax purposes. Donald Cave was the corporation's president, made corporate decisions, and received a percentage of legal fees. The court held that Cave's management services in the capacity of the corporation's president were not provided as an independent contractor. Numerous factors supported employment status for associate attorneys, hired by Cave in his purported activity as an "an attorney incubator"; they were found to be sufficiently under the control of the corporation, the corporation provided facilities, while the associates' compensation was on a percentage basis, they bore no risk of loss, the relationship was "continuous, permanent, and exclusive, there was no evidence that the associate attorneys provided services to anyone else, and the associate attorneys provided everyday professional tasks in the corporation's business. The court also denied independent contractor status under the safe harbor of § 530 of the 1978 Revenue Act finding no reasonable basis for the corporation to have treated the attorneys as independent contractors. The corporation was also required to pay failure to deposit tax penalties under § 6656.

7. **Employed and self-employed at the same time.** Rosenfeld v. Commissioner, T.C. Memo 2011-110 (5/23/11). The taxpayer, who maintained a consulting business advising clients on marketing, accepted a three year full-time appointment with the British Consulate General (BCG) to perform services similar to those provided by the taxpayer to private clients. The court (Judge Dean) held that the taxpayer was an employee of the consulate for withholding purposes and not entitled to separately report income from the engagement on a schedule C. The court found employee status from based on the facts that the taxpayer worked under the control of the BCG, the taxpayer received a fixed salary for his services, and the taxpayer's services furthered BCG's goals. The court described as "neutral" the facts that, although BCG provided an office (whether or not the taxpayer used the office was irrelevant) the taxpayer incurred many costs associated with his work, the taxpayer's three year contract was not defined as long term, and that the either party could terminate the relationship without cause. The court also rejected the taxpayer's arguments that he was self-employed because the parties defined the relationship as an independent contractor relationship that specifically provided that the BCG would not withhold taxes, and the taxpayer received no employee benefits and concluded that the taxpayer was a common law employee of BCG.

8. **Part time professor as an independent contractor.** Robinson v. Commissioner, T.C. Memo 2011-99 (5/5/11). The taxpayer, a full time criminal justice professor at Rowan University, taught vocational classes at Temple University in its Criminal Justice Training Program. From 1985-1996 Temple treated the taxpayer as an independent contractor thereafter reported the taxpayer's compensation as an employee. The court (Judge Wells)

focused largely on the control test for employment status and found that the degree of control exercised by Temple over the taxpayer as a vocational instructor was less than the control normally exercised over an adjunct professor. The court noted that the taxpayer prepared the curricula for the courses he taught, mostly covering topics mandated by the State police commission that paid Temple. The court added that the only control Temple exercised over taxpayer's work updating curricula was to set deadlines and convey the general topics he was to cover. The court also noted that Temple did not provide the taxpayer an office or other space in which to write and update curricula, taxpayer's opportunity for profit and loss depended on how many courses he was hired to teach and was not dependent on the level of enrollment in each course (a risk borne by Temple), and that the record suggested that the taxpayer was hired for individual jobs thereby being asked to perform discrete tasks under varying payment terms. The court further cited that fact that teaching police training courses was not part of Temple's regular business of teaching for-credit courses to regularly enrolled students. The remaining factors considered by the court included that the taxpayer's relationship with Temple fluctuated over time rather than constituting a permanent position, the taxpayer was paid an hourly wage for teaching but a flat fee for writing curricula suggesting both an employee relationship and an independent contractor relationship, that Temple treated the taxpayer as an employee for reporting purposes, but provided no employment benefits. Considering all of the factors, the court found the taxpayer was an independent contractor. The court also denied multiple deductions claimed by both the taxpayer and the taxpayer's spouse on schedules C and A for lack of substantiation and imposed § 6662 penalties.

9. **Litigious attorney liable for employment taxes, no matter how many courts he tries.** Western Management, Inc. v. United States, 108 A.F.T.R.2d 2011-5261 (Fed. Cl, 9/9/11). Attorney Kovacevich practiced through his wholly owned and operated corporation as an independent contractor. Taxpayer withdrew funds from the corporation as needed. In addition the corporation paid multiple personal expenses for the taxpayer and his wife. On instructions from the taxpayer, the corporation's accountant treated disbursements to the taxpayer as loans and did not file forms 1099 for any of the payments. In a 2003 decision (T.C. Memo. 2003-162, *aff'd*, 97 A.F.T.R.2d 2006-1949 (9th Cir. 2006)) the Tax Court held that the Kovacevich was an employee and the corporation was liable for employment taxes, plus § 6662 penalties for the 1994 and 1995 tax years. The IRS subsequently prevailed against the taxpayer in a collection action in which the taxpayer asserted that checks credited against previous employment tax liabilities (also litigated in the Court of Federal Claims) should be applied to the 1994 and 1995 deficiencies. (T.C. Memo. 2009-160.) Kovacevich and the corporation filed a claim for refund of payments made by Kovacevich on the corporation's employment tax liabilities. The court granted summary judgment for the IRS, holding that the taxpayer could not re-litigate the prior Tax Court holdings that the taxpayer was an employee of the corporation. In addition, the court granted summary judgment to the Government, holding that Kovacevich was personally liable for the corporation's employment taxes, plus penalties and interest because the taxpayer operated the corporation as his alter-ego. Finally, the court held that the taxpayer's wife was also liable for the taxes and penalties under Washington community property law. There is a moral here.

10. **Voluntarily reclassify workers and pay less tax for last year.** Ann. 2011-64, 2011-41 I.R.B. \_\_\_ (9/21/11). The IRS announced a voluntary classification settlement program that permits accepted applicants to agree to re-classify independent contractors as employees and pay reduced taxes for the prior year. The program augments the existing classification settlement program that allows eligible taxpayers under examination for worker classification issues. The program is available to taxpayers that currently and consistently classify workers as nonemployees and who filed all required Forms 1099 for the previous three years. The program is not available to taxpayers currently under audit for worker classification issues. A taxpayer accepted in to the program who agrees to prospectively treat workers as employees for future tax periods will be able to pay 10 percent of the employment tax liability that might have been due on compensation paid to workers in the most recent taxable year and will not be subject to penalties or interest on the liability. The taxpayer will not be subject to an

employer tax audit with respect to worker classification for prior years. In addition, the taxpayer must agree to three year extension of the statute of limitations with respect to employment taxes for the first, second, and third calendar years beginning after the date on which the taxpayer has agreed under the program to treat workers as employees. The voluntary program is significantly more generous than the current classification settlement program.

**B. Self-employment Taxes**

1. **Self employment taxes reduced.** The Compromise Tax Relief Act of 2010, § 601, reduces self employment taxes from 12.4% to 10.4% for calendar year 2011

**C. Excise Taxes**

1. **Telephone excise tax trouble for the government ahead.** Cohen v. United States, 578 F.3d 1 (D.C. Cir. 8/7/09) (2-1). In this telephone excise case, Judge Janice Rogers Brown's majority opinion held that the telephone excise tax challenge litigation violated neither (1) the Anti-Injunction Act, 26 U.S.C. § 7421(a), which provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed" nor (2) the Declaratory Judgment Act, 28 U.S.C. § 2201(a), which allows for declaratory relief but specifically excludes federal taxes from its reach, because (1) the standalone Administrative Procedure Act, 5 U.S.C. § 702, claim in the instant case is "the anomalous case where the wrongful assessment is not disputed and the litigants do not seek a refund," and (2) the Declaratory Judgment Act is coextensive with the Anti-Injunction Act (citing circuit precedent). Judge Brown began her opinion:

Comic-strip writer Bob Thaves [creator of *Frank and Ernest* (1972)] famously quipped, "A fool and his money are soon parted. It takes creative tax laws for the rest." In this case it took the Internal Revenue Service's ("IRS" or "the Service") aggressive interpretation of the tax code to part millions of Americans with billions of dollars in excise tax collections. Even this remarkable feat did not end the IRS's creativity. When it finally conceded defeat on the legal front, the IRS got really inventive and developed a refund scheme under which almost half the funds remained unclaimed. Now the IRS seeks to avoid judicial review by insisting the notice [Notice 2006-50] it issued, acknowledging its error and announcing the refund process, is not a binding rule but only a general policy statement.

- Judge Brown stated that the IRS position was "just mean," and that it "places taxpayers in a virtual house of mirrors." She continued, "Despite the obvious infirmities of [the IRS position], the IRS still has the chutzpah to chide taxpayers for failing to intuit that neither the agency's express instructions nor the warning on its forms should be taken seriously."

- Judge Brown concluded, however, that "[a]ppellant Neiland Cohen filed his refund claim prematurely and, [we] thus, affirm the District Court's dismissal of his refund claim." The case was remanded to the District Court for its consideration of the merits.

- Judge Kavanaugh dissented, stating that the appellant could simply have followed the procedures of Notice 2006-50.

- The D.C. Circuit granted rehearing en banc, 3/11/10.

a. **A case warning that tax professionals continue to ignore administrative law at their (clients'(?)) peril. The panel holding was upheld on rehearing en banc.** Cohen v. United States, 108 A.F.T.R.2d 2011-5046 (D.C. Cir. 7/1/11) (6-3). In upholding its original panel decision to remand the case to the District Court for its consideration of the merits, Judge Brown wrote the majority opinion that held the suit was not precluded by either the Anti-Injunction Act or the Declaratory Judgment Act. Judge Kavanaugh's dissent emphasized that this suit was merely a prelude to a class action suit seeking monetary relief from the government, and that there was an adequate remedy in individual refund suits following claims for refund under the procedures of Notice 2006-50 in which all claims under the Administrative Procedure Act could be asserted.

• **Enough, already!” The IRS cries, “Uncle.”** Notice 2006-50, 2006-1 C.B. 1141 (5/26/06), *revoking* Notice 2005-79, 2005-2 C.B. 952. The IRS announced that it will stop assessing the § 4251 telephone excise tax on long distance services, and that it will provide for refunds of taxes paid on services billed after 2/28/03 and before 8/1/06. These refunds are to be requested on 2006 Federal income tax returns, the right to which will be preserved by the IRS scheduling overassessments under § 6407. Individuals are eligible to receive a safe harbor amount, which has not yet been determined. Interest received on the refunds will have to be reported as 2007 income.

## **XII. TAX LEGISLATION**

### **A. Enacted**

1. H.R. 3590, the **Patient Protection and Affordable Care Act** (“PPACA” – pronounced “pee-pac-a”), P.L. 111-148, was signed by President Obama on 3/23/10, and H.R. 4872, the **Health Care and Education Reconciliation Act of 2010** (“2010 Health Care Act” or “2010 Reconciliation Act”), P.L. 111-152, was signed by President Obama on 3/30/10.

a. **The 2010 Health Care Act is constitutional, but the “penalty” is not a “tax.”** Thomas More Law Center v. Obama, 108 A.F.T.R.2d 2011-5007 (6th Cir. 6/29/11) (2-1). The Sixth Circuit Court of Appeals, in an opinion by Judge Martin, upheld the constitutionality of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. The majority opinion upheld the Act under the commerce clause. Judge Sutton’s concurring opinion, which also “delivered the opinion of the court in part” also concluded that the Act was constitutional under the Commerce clause, but held that the Act was not an exercise of the taxing power – the penalty for not purchasing health insurance was not a tax. An opinion by Senior District Judge Graham, concurring in part and dissenting in part, also held that the Act was not an exercise of the taxing power but would have held the Act unconstitutional as beyond Congress’s power to regulate commerce.

b. **But, on the other hand, the Eleventh Circuit holds that the individual mandate is unconstitutional.** Florida v. Department of Health & Human Services, \_\_\_ F.3d \_\_\_ (8/12/11) (2-1). The Eleventh Circuit held that Congress exceeded its authority by requiring Americans to buy coverage, but also ruled that the rest of the wide-ranging law could remain in effect. The case stems from a challenge by 26 states which had argued the individual mandate, set to go into effect in 2014, was unconstitutional because Congress could not force Americans to buy health insurance or face the prospect of a penalty. The majority stated:

This economic mandate represents a wholly novel and potentially unbounded assertion of congressional authority: the ability to compel Americans to purchase an expensive health insurance product they have elected not to buy, and to make them re-purchase that insurance product every month for their entire lives.

2. **The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010** (“the Compromise Tax Relief Act of 2010”), P.L. 111-312, was signed by President Obama on 12/17/10. It was a compromise arrived at between president Obama and Republican congressional leaders, and was based in part upon S. 3793, the Job Creation and Tax Cuts Bill of 2010, which was introduced on 9/16/10 by Sen. Baucus. The Act extends individual tax reductions (the so-called “Bush tax cuts”) for two years, contains economic stimulus incentives, and provides energy related tax breaks and disaster relief. Many provisions of the Act renewed various expiring and expired tax benefits for individuals and businesses, and they are thus sometimes referred to as the “Jimmy Johnson” provisions. The Act, §§ 301-304, also included estate, gift and generation-skipping transfer tax relief for the years 2011 and 2012, including “portability” of the marital deduction. It is the great post-election compromise of 2010.

3. H.R. 4, the **Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011**, was approved by the Senate on 4/5/11 following passage by the House. The bill would repeal the requirement that businesses submit a Form 1099 for payments made to a single vendor for goods and services totaling more than \$600 annually. The bill would be paid for by raising the amount of a healthcare tax credit that can be

recaptured from taxpayers in cases of overpayment. President Obama called for repeal of the 1099 provision in his State of the Union speech, and might actually sign the bill if it is brought to his attention between vacation trips. He did, indeed, sign it into law on 4/14/11.

4. The **America Invents Act of 2011**, P.L. 112-29, was signed by President Obama on 9/16/11. Section 14 of the Act provides that "any strategy for reducing, avoiding, or deferring tax liability, whether known or unknown at the time of the invention or application for patent, shall be deemed insufficient to differentiate a claimed invention from the prior art." This provision does not apply to computer tax return preparation products. It will not affect patents already issued.

**B. Pending**

1. The **American Jobs Act of 2011** was orally signed by President Obama on 9/8/11. It will reduce the unemployment rate to four percent, cause the oceans to recede and cure cancer. Lacking are a written bill (because the Congressional Budget Office perversely refuses to score speeches) and the trivial detail of congressional voting (rendered irrelevant by President Obama's multiple repetitions of the necessity of immediate passage of the yet-unwritten bill, which Congress perversely failed to do on 9/9/11).



# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

For the William & Mary Tax Conference

I. ACCOUNTING.....	1
A. Accounting Methods.....	1
B. Inventories.....	1
C. Installment Method.....	1
D. Year of Inclusion or Deduction.....	1
II. BUSINESS INCOME AND DEDUCTIONS.....	2
A. Income.....	2
B. Deductible Expenses versus Capitalization.....	3
C. Reasonable Compensation.....	7
D. Miscellaneous Deductions.....	8
E. Depreciation & Amortization.....	14
F. Credits.....	17
G. Natural Resources Deductions & Credits.....	19
H. Loss Transactions, Bad Debts, and NOLs.....	20
I. At-Risk and Passive Activity Losses.....	22
III. INVESTMENT GAIN AND INCOME.....	25
A. Gains and Losses.....	25
B. Interest, Dividends, and Other Current Income.....	32
C. Profit-Seeking Individual Deductions.....	33
D. Section 121.....	33
E. Section 1031.....	33
F. Section 1033.....	33
G. Section 1035.....	33
H. Miscellaneous.....	34
IV. COMPENSATION ISSUES.....	34
A. Fringe Benefits.....	34
B. Qualified Deferred Compensation Plans.....	35
C. Nonqualified Deferred Compensation, Section 83, and Stock Options.....	35
D. Individual Retirement Accounts.....	36
V. PERSONAL INCOME AND DEDUCTIONS.....	36
A. Rates.....	36
B. Miscellaneous Income.....	36
C. Hobby Losses and § 280A Home Office and Vacation Homes.....	37
D. Deductions and Credits for Personal Expenses.....	38
E. Divorce Tax Issues.....	40
F. Education.....	41
G. Alternative Minimum Tax.....	41
VI. CORPORATIONS.....	42
A. Entity and Formation.....	42
B. Distributions and Redemptions.....	43
C. Liquidations.....	44
D. S Corporations.....	44
E. Mergers, Acquisitions and Reorganizations.....	45
F. Corporate Divisions.....	48
G. Affiliated Corporations and Consolidated Returns.....	48
H. Miscellaneous Corporate Issues.....	48

VII. PARTNERSHIPS .....	50
A. Formation and Taxable Years .....	50
B. Allocations of Distributive Share, Partnership Debt, and Outside Basis .....	51
C. Distributions and Transactions Between the Partnership and Partners .....	57
D. Sales of Partnership Interests, Liquidations and Mergers .....	57
E. Inside Basis Adjustments .....	57
F. Partnership Audit Rules .....	57
G. Miscellaneous .....	62
VIII. TAX SHELTERS .....	62
A. Tax Shelter Cases and Rulings .....	62
B. Identified "tax avoidance transactions." .....	65
C. Disclosure and Settlement .....	71
D. Tax Shelter Penalties, etc .....	71
IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING .....	75
A. Exempt Organizations .....	75
B. Charitable Giving .....	75
X. TAX PROCEDURE .....	80
A. Interest, Penalties and Prosecutions .....	80
B. Discovery: Summonses and FOIA .....	87
C. Litigation Costs .....	87
D. Statutory Notice of Deficiency .....	88
E. Statute of Limitations .....	88
F. Liens and Collections .....	99
G. Innocent Spouse .....	101
H. Miscellaneous .....	105
XI. WITHHOLDING AND EXCISE TAXES .....	110
A. Employment Taxes .....	110
B. Self-employment Taxes .....	117
C. Excise Taxes .....	117
XII. TAX LEGISLATION .....	118
A. Enacted .....	118
B. Pending .....	119

THIS PAGE INTENTIONALLY LEFT BLANK